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IMITED PARTNERSHIP ROLLUP REFORM ACT OF 1993—S. 424

HEARING

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON NKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

ON

S. 424

AMEND THE SECURITIES EXCHANGE ACT OF 1934 WITH RESPECT TO LIMITED PARTNERSHIP ROLLUPS

APRIL 20, 1993

ited for the use of the Committee on Banking, Housing, and Urban Affairs

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LIMITED PARTNERSHIP ROLLUP REFORM ACT OF 1993—S. 424

TUESDAY, APRIL 20, 1993

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, DC.

The subcommittee met at 2:34 p.m., in room SD–538 of the Dirksen Senate Office Building, Senator Christopher J. Dodd (chairman of the subcommittee) presiding.

OPENING STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. The hearing will come to order.

Any more room at that table?

[Laughter.]

Senator GRAMM. Bring in the additional witnesses.

[Laughter.]

Senator DODD. First of all, thank you all for coming here today. I apologize for the crowded circumstances here. But before I get into the substance of my opening remarks, I would like to lay out a couple of ground rules.

There are a lot of witnesses. It's important to try to get some interchange here. So we're going to move down the table and I'll ask all of you to keep your opening remarks very brief. We'll take all of your full statements and your supporting documentation and include those in the record. But if you'd get right to the heart of the arguments as quickly as possible, then we'll be able to engage in a discussion here of the merits and demerits of the proposals.

Now, having said that, I don't know if there's a meter around here, or a clock—I don't like these clocks and meters, but I know of no other way to do it. And so, if we apply the same standard to everybody, then no one's disadvantaged by it.

So why don't you see if you can get one of those clocks and we'll run off the clock, if that's all right with you, I say to my colleague from Texas.

Let me again welcome all of you here today to consider S. 424, the Limited Partnership Rollup Reform Act of 1993. This legislation is identical to the legislation that passed the Senate last year with the support of 87 Senators. It now has some 38 cosponsors, including a majority of this committee, and the list is growing. Legislation on this subject passed the House of Representatives last month by a vote of 408 to 6.

There is a reason, I believe, why so many members of Congress support the legislation. Our constituents, not special interests at

all, but small investors in our States, have documented a long record of abuses in limited partnership rollups, that they've been ripped off and hurt and they've asked for our help.

Investors have received misleading and confusing, to put it mildly, disclosure documents. Investors have been pressured to vote in favor of rollup transactions by brokers who are being paid only if they produced yes votes. General partners have structured deals to award themselves abusively high fees in the rolled-up entities and to pay high fees to affiliates.

Investors who have voted against a roll-up have been forced to accept shares in a new corporation, often with substantial reductions in their voting rights, but the voting rights of managements have increased.

And last, investors have been forced to accept shares in a new entity they didn't want, with a management fee structure that ensured that management would be paid first and investors last.

Those are the complaints that have come in. I happen to think that limited partnerships are terrific investment tools for people, particularly people of modest means. And the last thing I want coming out of this committee or hearing is, at least for my own part, and I can't speak for Senator Gramm, but I suspect that he agrees with this statement, that these are very good tools, and I don't want anyone to misread what these hearings are about in terms of the general notion of how attractive an investment opportunity these partnerships can be.

And obviously, many of them, the overwhelming majority, are run very, very well. But the laws aren't passed necessarily for the overwhelming majority. We have to deal with the abuses that occur, and there are highly substantiated abuses that occur.

So what I've outlined here are the list of some of those, the list of abuses that have occurred. No one has disputed the extent of these abuses. No one has disputed that in far too many cases, the rights of investors have diminished as a result of a rollup and the rights of management, voting rights, equity interest, management fees, and the ability to engage in affiliate transactions have increased.

This has happened in one deal after another across the country. In many of these transactions, the price of securities issued in the rollup have lost 20, 30, or 40 percent or more, in some cases, on the first day of trading. In some cases, the securities are now trading at a loss of up to 80 or 90 percent.

Of course, other economic factors have been at work, contributing to large losses in partnerships that have invested in real estate and oil and gas properties.

But when we have seen managements lining their pockets first, making sure they get paid first, and investors last, when we have to question whether some of these deals have been structured to the benefit of investors, or for the benefit of general partners.

We started this legislative process over 2 years ago, in 1991, after spending much of the previous year urging the SEC to take action. For many months, the SEC told us there wasn't any problem. They said investors understood the risks.

Finally, after legislation began moving in the House and in the Senate, the SEC began to take action on several fronts. The NASD

adopted rules and has additional rules pending. And when no Federal legislation was passed last year, the State of California passed a law covering rollups. And I suspect other legislatures across the country are moving in this area as well. Thus, the real question this morning is not whether there have been abuses. We all agree that there have been.

The question is whether the rules adopted by the SEC, the NASD, and the State of California adequately address those abuses. Are there gaps that we need to address? I have no desire whatsoever to go and pass a bill for the sake of passing a bill at all. Are there gaps in what the SEC has done, and the NASD, that we ought to fill? That's number one. It's very important to me that we get an answer to that that makes some sense. If that's not the case, and I know there are some of you here who believe that, then there's no reason to pass a piece of legislation.

And then, second, do you want uniformity, from the business community's perspective? Or do you want California, Connecticut, Texas, Illinois, Arkansas, going along to develop their own set of rules here and just driving you to distraction and nuts on this issue? Or should we have a standard set of rules that apply here that make sense to everybody?

Those are the two basic questions that this hearing is all about. Are there gaps? And what makes more sense in this area, standard rules or not? So that's what I'm anxious to hear from the witnesses.

At any rate, also know that from the perspective of partnership sponsors, we have to ask whether there will be unintended consequences. If we act, will we inhibit beneficial transactions? If we pass a new Federal law, could new Federal laws be good for business providing certainty and, as I said, uniform standards?

At any rate, we thank all of you for coming this afternoon and hopefully, we can move along fairly quickly here and get to your comments, have a good, brief discussion about this, and then, with Senator Gramm's cosponsorship, we ought to move this legislation very quickly.

[Laughter.]

OPENING STATEMENT OF SENATOR PHIL GRAMM

Senator GRAMM. Well, Mr. Chairman, let me first thank you for holding this hearing. I appreciate it very much.

Let me outline the concern I have about this bill. It's impressive that so many people have voted for this bill. I think that is a testament, really, to two things. Number one, when people write to their congressman telling them that there's a problem, the natural tendency in Congress is to change law.

Second, we have had organized groups push this, and if anybody believes in the right of people to petition their Government, it's me. And certainly, people have every right to form associations and push legislation. That's what makes America work. The problem, it seems to me, is this, and let me just go into a little bit of detail, Mr. Chairman, because I think, largely, I'm the reason we're holding this hearing, and maybe have had something to do with this bill not becoming law.

I'd like to outline my feelings about it.

We had a dramatic change in the 1980's, especially with regard to the real estate industry. Several things happened, the most important of which was that we stopped inflation in America. People were buying real estate as a hedge against inflation. Values were inflated as a result of anticipation that the inflation of the late 1970's would continue or, in fact, accelerate. We had a dramatic change in tax law in 1986 that lowered the asset value of real estate. And so, what happened during the 1980's was that a substantial number of limited partnerships, especially in real estate, turned out to be very bad investments.

In trying to deal with these investments, the limited partner have had several options. One was to sell off the investment. That often was a very difficult thing to do. It meant the loss of a lot of money and, in many cases, the limited partnerships didn't want to do that.

The next option was to sell partnership interests to a fund that might be established to buy out troubled limited partnerships, and, given deeper pockets or clearer vision or some other capacity they felt that they had that the limited partners didn't have, to salvage the deal.

The final option that was available was to rollup the partnership into a corporate entity, for example, where individual investors could sell off their shares in a national market.

If people bought real estate in the late 1970's and early 1980's, through a limited partnership, and that limited partnership got into trouble because real estate values had declined precipitously, and they rolled up the asset into something that could be sold on an equity market, not surprisingly, on the first day that equity was sold it reflected the real loss.

Now, limited partnerships are very, very important. They're a vehicle, as the Chairman said, whereby people can put together capital to undertake deals that in many cases could not be undertaken, except by large entities.

It is a vehicle whereby average citizens can become part of large equity investments. As a college professor, I participated in several limited partnerships. Because of the period I entered into them, and because of their nature, I lost money on almost every one. I was never a general partner; I was always a limited partner. But the losses primarily were a result of the fact that you had a dramatic change in the real estate market. Nobody ever tried to roll one up. And I don't know what would have happened had that been the case.

There is no constituency, at least focused, that I've ever been able to identify, that is willing to be mobilized on the concerns I have with this legislation, but I feel very strongly about it.

I am very much in favor of giving people information. I have no objections to about four-fifths of the bill before us. I think reporting, I think giving people the facts, I think engaging in public education, those are good things that help the market work better. I am pleased by what the SEC has done and by what the NASD has done.

My concern with the bill is almost totally focused in the part of the bill that would go back and, through a change in law, give rights to limited partners that they did not have when they entered

into the agreement and that they never had any legitimate reason to believe that they would have.

Let's say that everybody at the table, and Senator Dodd and I, entered into a limited partnership. And let's say we went out and bought a piece of real estate, and the investment went bad. We had assumed the city was going to grow in one direction or it was going to grow at a certain rate and it didn't. So the partnership is in trouble and we're trying to decide what to do.

Under existing procedures, the majority could come up with a proposal to sell the land, to roll it up into a corporate entity, or to sell our interests to some fund that might then be able to do a better job of managing it than we could.

But the principle is that we all signed the agreement that said what our rights were. And our rights contain the ability of the majority to amend the agreement, or whatever we signed as a structure, and that we knew those were the rights we had.

Now this bill would come in and change that contract to attribute minority rights where they did not exist before. The problem is you can't give rights to one group of people without taking property, value and rights, away from another group of people.

What this bill sets up is the ability of a small number of investors to limit the capacity of the majority to exercise rights that they were guaranteed when they signed the contract.

I think the problem is potentially even worse, because States usually require the registration of limited partnerships the list of which is publicly available. Those who might want to buy limited partnership interests, such as a fund specializing in such purchases, could approach members of the limited partnership, offering them a premium to purchase their interests and then hold out and demand minority rights. I think it's full of potential mischief, and that it clearly violates the sanctity of contracts.

Now there are several ways we could go. First of all, we could do the reporting, give people the information, and let people make decisions.

Second, we could change the law prospectively by saying that contracts entered into in the future would have to have a clause that says that minority investors would be protected from a decision of the majority, unless they agreed to it.

Now I would argue that that would be bad policy, because we're limiting the ability of free people to enter into a voluntary contract, and we're probably diminishing the capacity of limited partnerships to work. But at least we're not changing the rules of the game.

I think the third option, and the one that I am most strongly against, is changing the law so that if you and I entered into a contract and we set out an agreement which was fully legal, fully enforceable in the courts, and the majority of the members of the agreement had the right to believe that they could sell the asset, roll it up, make rational economic decisions, then we come in after the fact and limit your ability to do that. In that case we have taken your property. We have lowered your ability to get what you perceive to be the full value of your asset.

The issue here is not one interest group against another. Clearly, to the extent there's any political base on this issue, it is in favor of the bill.

What is at issue here, it seems to me, is a very powerful tool for economic development, which is the limited partnership, and then the fundamental principle about the viability, or the inviability, in this case, of contracts that were legal, that were entered into by consenting adults.

Finally, Mr. Chairman, let me say, and it's a pretty strong point, but I believe it—I never cease to marvel at, in this great temple to American democracy, that we will stand and defend to the death the right of any two consenting adults to engage in any behavior, no matter how we might personally view it, except the activity to create jobs, to make investments, to undertake risk, to create wealth. If someone is trying to do that, they stand naked before the world. There seems to be no organized effort to try to protect them.

And so, on this one issue, on violating contracts, I feel very strongly. I would like to support this bill. I hope we can work something out on it. I understand how the system works, and, obviously, there are a lot of people that are for the bill.

But I want you to know how I personally appreciate you holding this hearing, to give me an opportunity to be heard on an issue that I feel very strongly about.

Senator DODD. Not at all, and I thank you for that. Let me just quickly respond.

The reason is because the positions of the partners, consenting adults, is the level playing field, the knowledge and the awareness.

I don't have one with me, but these prospectuses; there's one right there that's being held up by Mrs. Heyman, and I agree with Phil, people of limited resources, in most cases, people not of great wealth, which allows them to be a part of larger deals, are asked to get involved in these kinds of arrangements which are far beyond their knowledge levels or awareness without hiring accountants and lawyers. So the analogy doesn't quite hold up.

And let me just mention, on the point about the viability of the contract, in a sense here, the reason you've got a problem is because it's the principals here, the general partners, who are changing the rules, when you go to a rollup. That's not what the original deal was, when you change the terms of the arrangement, you move into a new entity, and in a sense general partners are saying, "I'm sorry, you may not have known about that, we didn't tell you about that originally, but, that's what we're going to do. You signed onto this arrangement. We're changing this entirely. And we're going to also change your rights."

I don't disagree with your general point, but I think, in fairness, you've got to say that there's a change that's occurred here and, as a result, we allow those investors to have some ability to respond to it, is fair.

Senator GRAMM. Well, Chris, I don't want to get into a long debate, but just look at this. This is a prospectus, and there are a lot of complicated provisions in here. But people have a right to go into court if their rights are not upheld—if the commitments that were made in the agreement were not lived up to.

The point is, what we're doing here is say when, you sign an agreement, involving everybody at the table and you and me and the agreement says that the majority rules, we are not going to protect that contract.

The Government is now going to come along and pass a law that says, no, the majority doesn't rule. If two people say "no," then you've got to buy them out in order to sell your asset or role it up or whatever you want to do with it. We're giving them rights that they never had agreed to, that we had never agreed to.

Senator DODD. We want to listen to our panel here today, however, again, I think when you so fundamentally change the relationship and the nature of the investments, as the general partners can do, then you've got to be able to say that those investors should have some rights, even if they're minority rights, it is changed dramatically.

And so, I guess the nature of who creates the kind of change, is a point of some dissent.

Senator Murray.

OPENING COMMENTS BY SENATOR PATTY MURRAY

Senator MURRAY. Well, thank you, Mr. Chairman. I won't make a long statement.

I just found the last conversation fascinating, listening to my colleague from Texas describe the importance of majority rights over minority rights, after watching my first filibuster in the Senate.

[Laughter.]

That was just a comment I could not resist.

[Laughter.]

I am really delighted that you're having this hearing today and I'm looking very much forward to the discussion because I think this is responsible legislation and will probably go a long way to reform some of the abuses that we've seen.

I especially want to welcome Mr. Barbo, who is on your panel today, because as a general partner who supports this legislation, he brings a very needed viewpoint and I particularly want to thank you for coming.

And thank you, Mr. Chairman, for having this hearing.

Senator DODD. Thank you, Senator. My apologies in rushing to the witness table without asking for opening statements and comments.

Estelle and Robert Heyman, we'd be glad to take your testimony.

STATEMENT OF ESTELLE AND ROBERT HEYMAN, INVESTORS, BELLMORE, NY

Ms. HEYMAN. Good afternoon, Mr. Chairman, ladies and gentlemen. My name is Estelle Heyman. I am a New York City school teacher and I'm here today with my husband Robert, who is a guidance counselor, also in New York City. I would like to mention that we both hold masters degrees because I'm a little embarrassed by the events I am about to relate to you.

I think we could basically be considered unsophisticated investors who were trying to make an intelligent decision by diversifying our investments. With our backgrounds, we should have been able to understand what was happening to us in the rollup of our limited partnership and to have had some control over the disastrous outcome. Since we still own other limited partnerships, we are very concerned about the future of legislation regarding limited partnerships.

In 1983, we were advised by a stockbroker at E.F. Hutton to buy a limited partnership called Hutton/Apache Energy Income Fund L.P. We wanted an investment that would help us finance our daughter's college tuition. This investment was to be low risk, with an anticipated life of 7 years.

The objective was never realized because, in 1990, Hutton/Apache Energy Fund was involved in a rollup. At that time, we didn't even know what a rollup was. The first time we realized that there was going to be a change was when we received a prospectus/proxy from Hallwood Energy Partners L.P. It contained approximately 150 pages of charts and explanations about an EDP merger. It was filled with complicated and almost indecipherable terminology, such as selected historical and proforma financial information, the method of determining conversion ratio, consolidated statements of cash flow and operations, et cetera.

Although my husband and I had taken economics 101 sometime back in our college days, we honestly could not understand too much more than the fact that Hutton/Apache would now be Hallwood Energy Partners L.P.

We received a letter of transmittal. It seems a fait accompli. We were asked to submit our shares of Hutton/Apache Energy Fund, which had cost us $5,000, and in return, we would receive 53 units of Hallwood Energy Partners L.P., now valued at $490.

Believe me, now we understood what had happened. We felt that we had been taken.

I feel that if S. 424 had been law at the time of this rollup, we would have been in a position to understand what was happening to our investment. The general partners had the complete advantage.

As a limited partner, we were the ones who were not properly informed. S. 424 would have made it possible for the limited partners to have communicated with each other to discuss the rollup. There would have been alternatives offered for dissenting limited partners and restrictions on the fees and commissions paid in the rollup.

In the Hallwood rollup, the cost was an unbelievable $10 million. The differences between the partnership and the new entity would have been clearly and prominently explained by comparisons, with fuller disclosure. It would have been understood that the anticipated life now changed from 7 years to 50 years, that a lower risk original investment had now become a high-risk investment, allowing for exploration and development, that net cash flow would no longer be required to be distributed, but could now be reinvested, and that now, a two-third vote would be needed to remove the general partners, instead of the original 50 percent.

As you can see, we certainly would have been in a much better position if S. 424 had been law at the time of this rollup.

We are now left with an investment that has gone from a value of $5,000 in 1983 to a disastrous $490 today. We did not have the money that we anticipated would help pay our daughter's college tuition and had to take a loan. With the anticipated life of the original investment now changed from 7 years to 50 years—that's the year 2035—this investment won't even help us in our retirement.

The last point that I feel is very important is the need for dissenters' rights or other alternatives. The rules of fair practice in S. 424 are needed for the protection of the investors. The full disclosure should be concise, with understandable terms that clearly compare the objectives and current status of all partnerships involved in the rollup. The SEC should be commended for their role in this area.

Hopefully, with a provided list of other shareholders, it would be possible to speak to other limited partners and make an intelligent and discriminating decision, without feeling that you, as a limited partner, were being steamrolled into a vote that could affect your investment for the rest of your life.

Unfortunately, we own other limited partnerships. I urge you to protect our investments and the investments of the other unsuspecting investors whose limited partnerships have not yet been threatened by these unfair practices.

Please, safeguard our partnership rights by enacting S. 424, the Limited Partnership Rollup Reform Act of 1993.

Senator DODD. Thank you very much, Ms. Heyman.

Mr. Nelson is from Dallas, TX, an investor.

STATEMENT OF J. ROBERT NELSON, INVESTOR, DALLAS, TX

Mr. NELSON. Right. Thank you, Mr. Chairman.

Ladies and gentlemen, my name is Bob Nelson and I live in Dallas, Texas. I retired in 1987, after 32 years with a family owned oil and gas company. I am here to ask your support to the bill to reform limited partnership rollups, S. 424.

Working with a financial adviser during the early to mid-1980's, and with an eye toward retirement in 7 to 10 years, I invested in seven limited partnerships—five in real estate, one in oil and gas, and one in merchandising. While they all have suffered, only two have been subject to rollups.

Senator DODD. What years were those investments, Mr. Nelson?

Mr. NELSON. In the early 1980's, early to mid-1980's.

In 1983, I invested $15,000 in an oil and gas partnership called NRM 83D Income Fund. For the next couple of years, the return on this investment was acceptable. But in 1985, this fund was combined with other NRM-operated funds and became a stock company listed on the American Stock Exchange as NRM Energy Company Limited. I received 98 shares in this new company which were worth approximately $6,000.

Immediately after becoming a stock company, distributions continued, but within a year, it dropped 90 percent and within 3 years, had stopped. In 1989, the company was merged with another of theirs called Edisto Resources. In 1991, Edisto offered to buy my 47 shares for $119, and with no brokerage fee, I jumped at the offer. At least I got out before Edisto declared bankruptcy.

In 1986, I invested $5,000 in the Concord Milestone Income Fund, L.P., primarily because it was not a leveraged real estate partnership and had some tax advantages. Until the proposed rollup, the investment performed as expected. In the latter part of 1990, I received notice that this fund would be merged with another and be called Milestone Properties, Inc.

I voted against the proposal and, as a result, received a couple of telephone calls asking me to reconsider. I told the caller I didn't think the merger of the two funds was a good deal for my fund and that my no-vote stood. With the merger, my units became 87 shares of common and 272 shares of preferred, with my investment now worth about $3,600, and the annual return of about $400 was halved.

I sold my shares in Milestone in October, 1992, for $1,472. I understand that I will be receiving some additional income as a result of a class action suit, but I'll not hold my breath waiting for it.

That is the story of my experiences with partnership rollups and I again would request that you support the Limited Partnership Rollup Reform Act of 1993, since I have two more partnerships that I feel are candidates for rollup.

Thank you.

Senator DODD. Thank you very much. We've got Texas in a row here.

Mr. Bridges, we thank you for coming. Mr. Bridges is the president of the Kelley Oil Corporation from Houston, TX.

Thank you for being here.

STATEMENT OF JOSEPH BRIDGES, PRESIDENT, KELLEY OIL CORPORATION, HOUSTON, TX

Mr. BRIDGES. Thank you, Mr. Chairman, Senators.

My name is Joe Bridges. I'm the president of Kelley Oil Corporation. Kelley Oil serves as the managing general partner of Kelley Oil and Gas Partners, Limited, and publicly held development drilling programs, which I'll call DDP's, that are offered each year to unit-holders in Kelley Partners.

Exchange offers have been an integral part of the original business plan of these successful partnerships. Our experience as their sponsor leads to the conclusion that rollups can be beneficial to investors. They are already well regulated. And any additional rollup requirements should at least be flexible enough to avoid unintended results.

Kelley Partners was formed through an exchange offer completed in January, 1986. The transaction involved 21 programs with over 1,100 investors, and was structured to preserve the historical business relationships and options that were the cornerstones of the original program.

Four features were essential: A requirement for quarterly distributions of at least 75 percent of operating cashflow; an opportunity to invest in further development through the right to participate in DDP's; a requirement that Kelley Oil purchase all units in DDP's not purchased by unit-holders; and an objective for Kelley Partners to acquire the properties of the DDP's through exchange offers.

This structure allows Kelley Partners to expand its reserve base at a relatively low-risk level, while preserving its capital. Kelley Oil has sponsored six DDP's, one each year since 1987, for a total investment of approximately $155 million.

Since its inception in 1986, Kelley Partners has made distributions to investors totalling $9.59 per unit, with a current per-unit distribution rate of $1.20 per year.

During this period, Kelley Partners has almost tripled its reserves. Kelley Partners units were $12⅛ at inception and have averaged around $15 during the last year, while average prices for natural gas decreased 25 percent in the same period.

Kelley Partners has completed separate exchange offers for interests in each of the first three DDP's. The rollups reflected returns exceeding 35 percent and 50 percent per annum for the first and second DDP's, and a negative return for the third DDP. Kelley Partners has recently filed an exchange offer for the fourth DDP, indicating return of about 30 percent per annum.

The approval rates for the prior DDP rollups averaged over 98 percent. A few investors did not respond at all. But only a single investor cast a negative vote. Of the 17,590,000 units eligible to vote in these exchanges, that single nonconsenting investor owned only 10,000 units.

Kelley Partners' 1992 exchange offer was reviewed by the SEC for compliance with the rollup disclosure rules added in October, 1991. The rules and review procedures were extremely rigorous, spanning more than 4 months. They resulted in a disclosure document that left no potential risk or possible disadvantage of the transaction unexplored.

We believe the SEC's revamped disclosure requirements and intense review procedures should be more than adequate to ferret out abusive tactics and curtail unfair transactions.

In October, 1991, the North American Securities Administrators Association effectively prohibited any securities offering by oil and gas programs, unless their partnership agreements include requirements for any rollup transaction in which the program might participate. In particular, the determination of the exchange value must be supported by an independent expert's appraisal. The requirements are specifically tailored to address appraisal issues unique to oil and gas programs.

Additions to the California code in September, 1992, require that Kelley Partners offer dissenters' rights based on a second appraisal. Kelley Partners sees no reason for a duplicate appraisal.

The appraisal requirements under the pending Federal legislation and the implementing rules proposed by the NASD will compound the duplication problem proposed by the California statute and neither of these are tailored to address appraisal issues unique to oil and gas programs.

For oil and gas programs like the DDP's, that already include a supporting appraisal, a second appraisal would be redundant and wasteful. The pending initiatives should at least be refined so that rollups are exempted from the requirement of offering dissenters a second appraisal.

By adding dissenters' rights that were never bargained for by investors or sponsors, the pending initiatives would unilaterally alter the contractual relationship among the parties, which, in our case, is a mutually satisfactory business plan that has been conducted for many years.

The pending initiatives may involve other unintended effects in particular situations or industries. They are being promoted when existing regulatory initiatives have been given inadequate time to

test their effectiveness and should be reconsidered or at least refined to eliminate the anomaly of duplicated requirements.

Thank you.

Senator DODD. Thank you very much.

Mr. Jefferies, Partnership Profiles, Inc., in Dallas. We thank you for being here.

STATEMENT OF SPENCER JEFFERIES, PARTNERSHIP INDUSTRY ANALYST, DALLAS, TX

Mr. JEFFERIES. Please allow me to begin by expressing my appreciation to the subcommittee, Mr. Chairman, for the opportunity to appear here before you today in support of Federal legislation to curb abusive rollups.

I've been following this legislation since it began over 2 years ago and would like to commend this subcommittee for its steadfast efforts to protect partnership investors from unfair rollups, despite the obstacles placed in its path.

The damage caused by abusive rollups to the savings of tens of thousands of small investors is both well documented and indisputable. To be fair, I must point out that there is nothing inherently wrong with the concept of a rollup; indeed, there are a number of benefits that can be derived through partnership consolidations.

Unfortunately, however, the vast majority of rollups done thus far have been structured by self-serving general partners in such a way that any potential benefits resulting from the rollups have been more than offset by negative factors. As a result, most rollups have been grossly unfair to investors, while unjustly enriching their general partners.

The reality of rollups is that investors have unwittingly voted in favor of even the most abusive transactions because of high pressure tactics by general partners, because investors never really understood what it was that they were voting on in the first place. As an experienced analyst, even I have difficulty trying to figure out these transactions.

To expect the average partnership investor or, or that matter, the average anybody, to fully comprehend a rollup proposal is unreasonable. If these transactions weren't so complex that the average person could understand them, the history of rollups might make for a movie that would move "Barbarians at the Gate" to the Disney Channel.

With the plight of rolled-up investors making its way to the mainstream media in recent years, various regulatory bodies, including the SEC, the NASD, and the State of California, have taken action to curb abusive rollups.

While these efforts are to be commended, they all fall short of providing the much needed investor safeguards and across-the-board consistency that only Federal legislation can provide.

With respect to the new SEC rules relating to rollups, in my opinion, this has amounted to little more than simply reshuffling the information in the voluminous and intimidating rollup documents provided to investors. This purely procedural change has provided no substantive protection to investors and can be likened to rearranging the deck chairs on the Titanic, as the saying goes.

The issue of abusive rollups has never been whether investors have been provided with complete and full disclosure, but whether the typical investor can fully understand what it is that's being disclosed.

A much more serious effort to protect investors from abusive rollups has been undertaken by the NASD, which should be commended for being proactive in responding to this problem. Unfortunately, however, the NASD's proposed rules with respect to rollups will only come into play if broker dealers participate in the rollup or if the new entity created by the rollup is to be listed on NASDAQ for trading.

With respect to the prohibition against broker dealers participating in abusive rollups, we already know that some of the most abusive of these transactions have taken place and haven't even involved broker dealers. Indeed, the trend in the partnership industry today is not to use a broker dealer when doing a rollup. Sponsors are opting to go this route for a number of reasons, not the least of which is the fact that it's really not even necessary to use a broker dealer. By not involving the broker dealer, rollup promoters hope to keep these controversial transactions off the radar screen to the extent possible, while also keeping transaction costs to a minimum.

To do a rollup these days, all a sponsor needs to do is hire a nonbroker dealer evaluation firm and a proxy solicitation firm with a toll-free phone number, and they're off to the races.

With respect to the NASD's proposal that a rollup must provide certain investor protections, or it may not be listed on NASDAQ, this prohibition would prove equally as hollow in stopping abusive rollups, since the other exchanges have been more than willing to list these transactions, even when they are the most abusive.

Indeed, it is not clear whether these exchanges have applied any standards at all when it comes to listing rollups.

By far, the most substantive effort to protect investors from abusive rollups has been carried out by the State of California. The primary ingredient of the recently enacted rollup law in this State is that it mandates that dissenters' rights be offered to investors rejecting a rollup proposal.

While the new California law represents an important step in protecting investors from abusive rollups, it should not be considered a viable, long-term solution to this problem.

Since the law applies only to rollups involving California's investors, its reach is somewhat limited. Further, it is my understanding that certain groups have recently begun quietly laying the groundwork to water down the California law through new legislation.

Despite the various regulatory attempts to stop abusive rollups, the fact remains that only Federal legislation can provide the comprehensiveness and consistency this matter deserves to ensure the protection of millions of partnership investors throughout the country.

The primary argument raised by those opposed to substantive rollup reform is that it would interfere with the existing contract between the general partner and the limited partners.

While one might consider the relationship between a general partner and its limited partners in this fashion, the reality is that

investors believe they were putting their money into an investment product alongside a trusted investment manager, not in some sort of one-sided contract that their investment manager might some day exploit for its sole benefit by doing something that had never before even been contemplated at the time the investment was formed. By legislating minimum standards to protect investors from abusive rollups, about the only right general partners will lose will be their perceived right to short-change their own unwitting investors through complex rollup transactions.

After reviewing the proposed Federal legislation, it is my opinion that if enacted, it would go a long ways toward rendering abusive rollups a thing of the past, while also providing much-needed uniformity and consistency on this issue.

With so many general partners actively maneuvering to hang on forever to the assets they have under management, and thus, annuitizing their fee streams, the motivation to do a rollup is now as strong as it ever was.

In closing, it is my belief that if Federal legislation curbing abusive rollups does not come to pass, and the spotlight is taken off these transactions, the SEC will be unable to keep up with all the new rollup filings flooding its offices.

Thank you.

Senator DODD. Thank you very much, Mr. Jefferies.

Mr. Louis Garday? Is that how you pronounce that?

STATEMENT OF LOUIS GARDAY, CHAIRMAN, NAREIT GOVERNMENTAL RELATIONS COMMITTEE, WASHINGTON, DC

Mr. GARDAY. Yes.

Senator DODD. I am not familiar with that acronym.

Mr. GARDAY. Well, we'll see if we can take care of that.

Senator DODD. He's the chairman of Government relations of NAREIT. We appreciate you being here.

Mr. GARDAY. Thank you. And thank you, Senators, for allowing us to appear.

I'm Louis Garday, senior vice president of the National Association of Real Estate Investment Trusts, NAREIT, and the chairman of the Government relations committee. I'm also the president and chief executive officer of Burnham Pacific Properties, which is a California-based REIT.

I'm here testifying on behalf of NAREIT, which represents over 150 tax-qualified REITS, and more than 650 professional firms, accountants, lawyers, analysts, and the like, involved in the REIT industry.

Although we have serious reservations about the proposed legislation, our association applauds the efforts the committee has made to bring attention to this problem. Your efforts have helped create a climate in the investment community that has, from the REIT industry's perspective, effectively halted the abusive transactions without the passage of any Federal legislation.

Two and a half years ago, when the rollup problem was gaining the attention of congressional committees, our organization stated in several meetings with congressional staffers that REITS not only were not part of this problem, but are in fact one of the probable solutions.

We were concerned then and now that the proposed legislation was overly broad and could negatively affect partners' ability to convert their partnership interests into publicly traded corporate securities.

We maintained then, as we do today, that investors in illiquid partnerships would be better off if their investment was in a corporation with an independent board of directors or trustees, with the full scrutiny and accountability of a publicly listed and traded company. In fact, the performance of our industry since those meetings has proven our point, that being that not everyone is losing money in real estate.

Total returns on the publicly traded REIT shares over the past 2 years have exceeded 25 percent per year on an annual basis. I do not believe that any other broad segment of the real estate industry can boast of those types of returns in these current economic times. More importantly, on a long-run, total return basis, the equity REIT industry has outperformed the S&P 500 index for the last 20 years.

It is this type of performance opportunity that we believe should be available to all investors, both large and small. We're afraid that the rollup legislation could foreclose these opportunities and bar the way to the public corporate form to tens, perhaps hundreds, of thousands of limited partners, leaving them locked in illiquid partnership indications, the market for which is shrinking every day.

Since the first rollup bill was introduced in Congress, numerous regulatory entities adopted rules to deal with the problem, including the SEC, NASAA, NASD, and the States of California and Massachusetts.

In addition, and perhaps more importantly, we believe that investors and the financial market places are more sophisticated today, as they simply will not accept the types of transactions that we saw and the types of abuses we saw in the past. It is fair to say that we believe that the purpose of this very legislation has already been accomplished and no corrective Federal legislation is needed.

Although we do not think any Federal legislation is either needed or appropriate, if Congress decides to enact a rollup bill, we believe very strongly that the Senate version is preferable to the recently passed House version.

To wit, first, we're concerned that the 18-month moratorium that is included in the House bill will have Draconian consequences for many legitimate transactions that are now in the planning stages.

Second, we're concerned that the mandated fairness opinion provided for in the House bill adds unnecessary costs and doubtful value to any transactions.

And finally, the inclusion of substantially economic equivalent entities within the definition of limited partnerships in section 2(a) of the House bill should be deleted. This provision arguably includes many of the existing and viable public REIT's in the definition, even though we were never part of the problem.

Senator DODD. We're against that House bill, too.

[Laughter.]

Mr. GARDAY. OK. We are also concerned that both the House and the Senate bills are too broad. Both bills begin by assuming that

any reorganization of any limited partnership, either alone or with any other entity, is indeed a rollup. Although there are a number of reasonable exemptions from the definition of the rollup, this legislation will discourage existing REIT's, like my own, from even considering acquiring properties from limited partnerships for any consideration than cash.

If Federal legislation is to be enacted, NAREIT recommends that it should define rollups to include only mergers between related limited partnerships that involve the types of abuses that were associated with rollups in the past. If the definition is not limited to those abusive rollups, at a minimum, exemptions should be provided for arms-length transactions between unrelated companies and, specifically, for nonacquisitive or nonmerger types of transactions, or transactions with existing, bona fide public companies.

We are also opposed to providing appraisal rights in any Federal legislation. In the interest of time, we refer to written testimony on this point.

And last, but certainly not least, if Federal legislation is enacted, we believe very strongly that it should pre-empt State law in the area of rollups, at least to the extent that the securities to be issued will be traded on a national stock exchange.

It may prove impossible to satisfy both Federal and State regulators on merger offerings. Pre-emption of State regulation is essential if any future transactions are to be successful.

Today, our industry is beginning to realize its full potential——

Senator DODD. You want a bill, don't you?

Mr. GARDAY. Pardon?

Senator DODD. You want a bill, don't you?

Mr. GARDAY. Not in its present form, Senator.

Senator DODD. There will be fifty of them around the country?

Mr. GARDAY. Pardon?

Senator DODD. You're going to end up with 50 of them around the country.

Mr. GARDAY. Well——

Senator DODD. Do you like the California law?

Mr. GARDAY. Not all of it, no, as it relates to our industry.

Senator DODD. I didn't mean to interrupt. I apologize.

Mr. GARDAY. Quite all right. Today, our industry is beginning to realize its full potential as the country's pre-eminent, securitized real estate investment vehicle. We believe our success is well deserved. And here's the crux of our argument.

The last thing we want to do as an industry is to find a flurry of abusive rollups resulting in embittered partners entering our industry as embittered shareholders. It makes no sense.

However, the proposed legislation risks doing just that, as the very investors we all hope to help are foreclosed of the opportunities left to them, such as merging their partnership interest into publicly traded real estate corporations.

Although cash acquisitions are not subject to the rollup rules, few of the initial offerings we're seeing in today's market place are strictly all cash deals.

Please, do not by statute draw a red line around all partnership assets and prevent their investors from benefiting from the capital available in the REIT industry.

Thank you for the opportunity of testifying. We'd like to note for the record that I'm also submitting a more detailed analysis of the rollup bill, along with a copy of our association's statistical publication, "REITWatch," all of which we'd like incorporated as part of my testimony.

Thank you.

Senator DODD. It will be and we thank you very much.

Mr. Goldberg, we thank you for being here. Mr. Goldberg is the director of Due Diligence, the First Vice President of Royal Alliance Associates, Inc., in New York City.

STATEMENT OF MARK GOLDBERG, DIRECTOR OF DUE DILIGENCE, FIRST VICE PRESIDENT, ROYAL ALLIANCE ASSOCIATES, INC., NEW YORK CITY, NY

Mr. GOLDBERG. Mr. Chairman, members of the committee, good afternoon. My name is Mark Goldberg. I am the director of Due Diligence and the first vice president of Royal Alliance Associates.

While I appear before you in my individual capacity and not as a representative of my company, the matters before this subcommittee impact my professional activities on a continuous basis.

Given my interest in the subject, I thank the subcommittee for the opportunity to testify and applaud the subcommittee for its interest in protecting a category of investors in desperate need of protection.

The eyes of many people, including general partners currently planning rollups, are on the activities of this subcommittee. Only the actions of the California Department of Corporations, in my opinion, have stopped the flood of rollup activity.

Pending the enactment of this legislation and adoption of rules, California may no longer be an obstacle to abusive rollups. It is therefore imperative for this legislation and guidelines to follow to be comprehensive. Otherwise, I fear that the intent of this committee to protect investors will be eluded.

It is time to address a national problem on a national basis. As you are aware, rollup transactions have received a large amount of generally adverse publicity and criticism from the press and Government officials in recent years. This has resulted in a flurry of activity, including NASD-proposed rules, NASAA enactment of rules and guidelines and legislation in California.

In spite of all this activity, the interest of general partners in rollups has not waned. To the contrary, the strong market for real estate investment trusts and interest on Wall Street in new REIT's has intensified the desire for sponsors to engage in rollup transactions.

Rollups will proceed in great volume, limited only by cost and regulatory barriers. The reasons are obvious. General partners are or are owned by human beings, who can be expected to act in their own economic self-interest.

Although the limited partners were sold their investment with the understanding that the partnerships would have a finite life, general partners naturally do not want to give up their control of the assets, and the revenues they generate in fees.

The incentives for general partners to attempt rollups are many. REIT's can raise money and increase assets under the control of

the general partner, something the partnership syndicator can no longer achieve. Rollups can also benefit limited partners.

The basic problem with rollups is without regulation to prevent abuse, the general partner may extort benefits for itself as the price for providing the benefits of the rollup.

Rollup transactions have taken place with one-sided solicitations by high pressure professional solicitation firms contacting generally uninformed investors. Their high-pressure calls are the key moment in the solicitation, especially since the rollup's prospectus, despite the commendable efforts by the SEC, remains indecipherable to the untrained investor.

Without regulation, there is no way to force the general partner to live up to its original promise and legal obligation to act as a fiduciary, solely in the interest of the limited partners to liquidate the properties at some point and not to deal in its own interest at the expense of limited partners.

I've been asked to direct my testimony to potential gaps and ambiguities in the current law and proposals. I believe there are several. However, they are technical in nature, so I would refer the committee to my written testimony for a detailed discussion. Of the seven outlined in my written testimony, let me touch upon one today.

We do not know currently if the NASD proposals will or will not result in exemption in California for rollups accepted for listing on NASDAQ NMS. If the NASD proposals eliminate the scrutiny of the California DOC, the comparable rights provision of the NASD rules become a method by which sponsors can avoid the imposition of dissenters' rights by regulators in California and avoid the dissenters' rights otherwise provided in the NASD rules.

This is but one of many very serious gaps and limitations on current investor protection. If left unaddressed, this will portend poorly for the potentially hundreds of thousands yet to face rollups. There still remains no definitive standard and there is no substitute for a Federal standard.

Mr. Chairman, and members of the committee, I believe that substantive regulation is justified when fiduciaries deal with assets of investors. We have heard the thought expressed that any restriction on the ability of 51 percent of the limited partners to agree with a general partner on a rollup is an interference with the right to contract.

That is a spurious argument. When the original public partnership was sold, a prospectus and a partnership agreement was completed with the involvement of State and Federal regulators. The original agreement, as required by state guidelines and also, as provided by State common law, expressly provided and represented to investors that the general partner was a fiduciary, bound to act in the interests of limited partners.

The fiduciary duty of a general partner to limited partners is one of the highest good faith. It is the equivalent of the duty of a trustee under a trust agreement. It is a violation of that duty for a fiduciary to demand benefits for itself in order to fulfill its duty to act for limited partners. Such a duty is not waivable, even if it is couched in the terms of amending a contract.

I believe this to be the heart of the matter. For over 50 years, Congress has seen the need to regulate those who have a fiduciary or other special relationship with an investor's assets, irrespective of any consent of the investor.

The Investment Company Act of 1940 regulates the actions of sponsors in respect to mutual funds and other investment companies. The Investment Advisers Act regulates how investment advisers deal with clients. The Securities Exchange Act of 1934 governs how broker dealers deal with clients. The Trust Indenture Act deals with how trustees must act under trust indentures that govern most debt offerings. ERISA of 1974 governs how all manner of fiduciaries and parties in interest deal with pension assets.

The general partner fiduciary of a public partnership may be a rare exception as a federally unregulated fiduciary dealing with the assets of public investors.

I believe we need to ask ourselves the age-old question—who will watch the watchmen?

Thank you.

Senator DODD. Thank you very much. Mr. Peabody, we thank you for coming.

Mr. Peabody, who is with Meigher, Peabody, in New York City, and we thank you for being here.

STATEMENT OF DOUGLAS PEABODY, MEIGHER, PEABODY & COMPANY, NEW YORK CITY, NY

Mr. PEABODY. Thank you, Chairman Dodd, and Senator Gramm.

My name is Doug Peabody. I'm president of Meigher, Peabody & Co. I'm here today representing Houston Biotechnology, Inc., or HBI, of the Woodlands, Texas, near Houston, in my capacity as a member of the board of directors. I should point out that I'm also a shareholder of HBI, as well as a limited partner of Houston Biotech Partners, L.P., a $27 million research and development limited partnership, affiliated with HBI.

Throughout 1991 and the better part of 1992, HBI and Houston Biotech Partners were engaged in the process of combining those two legal entities to the mutual benefit of the shareholders of HBI and the limited partners of the partnership.

While our transaction was quite straightforward by most everyone's objective standards, since it involved only the exchange of interests in a single partnership for common stock of a single related entity, we nonetheless got caught up in the regulatory web, like the proverbial mouse in the dance of elephants.

Prior to my present position in my own investment management firm, I was with Inco Venture Capital Management for 11 years, most recently as president and managing principal. We provided seed and early stage capital to well over 125 companies across many industry sectors, including many companies in the biotechnology industry which have become publicly held companies.

Among the companies we funded were Genentech, Biogen, ImmunoGen, the Liposome Company, and SCIOS-NOVA. Many of these companies use the R&D partnership as financing vehicles and have subsequently rolled them up without incident, to my knowledge.

HBI was founded in 1984 by two professors at Baylor College of Medicine. The company is engaged in the research and develop-

ment of biopharmaceutical products for the prevention and treatment of ophthalmic and neurological disorders. Its flagship product is an immunotoxin for the prevention of secondary cataract.

HBI was funded in 1986, with initial venture capital from my firm and with $27 million in R&D limited partnership funds raised publicly in 1987, through the direct investment group at E.F. Hutton.

The partnership was successful in the sense that the immunotoxin development progressed from the laboratory through preclinical trials into phase-one, human clinical trials, pursuant to an INDA with the FDA.

However, it became increasingly clear that much more money was going to be required. For various reasons which I will not dwell on here, the partnership, which owned most of the rights to the project, had no provision or capability for raising additional capital. The company, wherein the expertise to develop the project was resident, was not capable of raising additional capital to complete the development until the complex nature of the relationship with the partnership was sufficiently simplified.

Consequently, a combination was proposed by HBI management and the independent general partner of the partnership. It was approved by the HBI board of directors and by the HBI shareholders in July 1991, the month after the SEC proposed its new rules on rollups.

An S–4 registration statement was filed with the SEC on July 3, 1991, which, due to the confusion over the rollup rules, did not become effective until February 20, 1992, nearly 8 months later. The transaction was closed on April 30, 1992, with 76 percent of the units voting in favor and only 3 percent voting against. Our rollup cleared blue sky in 46 States.

I am told that HBI was the first partnership rollup to become effective under the new SEC rules.

Earning that distinction cost the company and the limited partnership nearly $1 million in expenditures relating to the registration process, a figure approximating 12.5 percent of the combined entities then tangible net worth, endless amounts of management time, and the opportunity cost associated with missing the biotechnology window in the new issues market which opened at the end of 1991, and then closed abruptly again before the end of the first quarter of 1992.

There can be no doubt that the regulations relating to partnership rollups proved very costly to HBI and the partnership.

Ironically, an argument can be made that the rollup legislation and regulations ought not to apply to biotechnology R&D partnerships at all. As far as I know, biotechnology R&D partnership rollups have not suffered the abuse attendant oil and gas and real estate partnerships.

In my discussions with committee staffers, no one has pointed out to me any evidence to the contrary in the legislative record.

Having passed one rollup registration through the SEC under the new rules, I am inclined to believe that those rules sufficiently address the problem. Although I am not an expert on the legislation under discussion today, I am told that, in addition to what the SEC rules require, the legislation would require registered securi-

ties associations such as the NASD, National Securities Exchanges such as the AMEX, and Automated Quotation Systems such as the NASDAQ, to prohibit participation in or listing of rollup transactions which do not offer dissenters' appraisal rights, among other things.

We did not offer dissenters' appraisal rights in our transaction for the simple reason that they were not appropriate. The partnership was organized for a fixed term to engage in research and development with no expectation of cash distributions for quite some time.

A conversion to stock ownership was contemplated and the rollup was the best means to an earlier liquidity event for all limited partners. To have depleted partnership cash to satisfy dissenters would have been unfair to the majority of partners wishing to continue in reorganized form.

In summary, we believe it is important in considering the legislation to take into account the regulatory burden to small issuers such as Houston Biotechnology, as well as the chilling effect the special requirements of such legislation, including a bar from listing for not including dissenters' rights in transactions, would have on the use of the partnership vehicle for financing emerging biotechnology companies.

On the other hand, we also believe that anything Congress can do to pre-empt State legislation in this area and clarify the rules would be beneficial to issuers and investors alike.

Thank you.

Senator DODD. Thank you, Mr. Peabody, very much.

Mr. Barbo, we thank you for being here. Mr. Barbo, I should point out, is the chairman of Shurgard, Inc., Seattle, WA.

STATEMENT OF CHARLES K. BARBO, CHAIRMAN, SHURGARD, INC., SEATTLE, WA

Mr. BARBO. Thank you very much, Mr. Chairman, Senator Gramm, for this opportunity to discuss this with you today.

As you pointed out, I am the chairman of Shurgard, and I am the general partner of approximately 20 public limited partnerships that were sold to the public in the timeframe of 1980 through about 1991. These partnerships include over 80,000 investors and approximately $700 million worth of capital contributed.

Every one of our partnerships is performing well. We did suffer a bit during the difficult real estate time. But overall they are performing well. We have no bankruptcies. We have no problems. We have had about 13 or 14 years of uninterrupted cash distributions to limited partners.

I support the enactment of this bill. I am currently in registration with the SEC for a rollup for the first 17 partnerships and, to my knowledge, we comply with every part of this bill. So I am living proof that it is possible to do a real estate limited partnership rollup under this legislation. I only wish it would take a little less time.

The issue for me is one of the general partners acting within their fiduciary responsibility. I believe that my judiciary responsibility as a general partner is to do those things that are called for in this bill.

I'm at a unique advantage in that I don't have highly leveraged real estate, so I can offer dissenting rights through notes and offer notes to nondissenters as well for additional choices on their part.

And Senator Gramm, I do believe, as you do, in the sanctity of contracts. The problem that I have as a general partner today is that previous general partners that have done rollups have violated that sanctity of the contract in many respects. In some respects, I am the victim of past general partner abuses. The scrutiny that we get now for something that is, I think, definitely in the best interest of the limited partner is the result of some of the problems that investors such as these people down here have had in the past.

I read the testimony before this committee in February 1991. One can't help but be concerned about what happened to some of those people. I think some of the abuses that have taken place are unconscionable.

In this environment you might ask, why are we doing a rollup at this time? A lot of people have asked me that. Well, it's a particularly good time. The REIT's are very, very popular right now because of low interest rates and a perception that we're at the bottom of the real estate cycle. And so, many people are investing in REIT's now.

Currently, Wall Street is paying substantially more for real estate than is Main Street. Some experts have told me the value differential is anywhere from 10 percent to 100 percent these days. So, in my opinion, if there is a general partner out there with real estate limited partnerships who is not considering a rollup of limited partnership today, he is not looking out for the best interests of his limited partners.

We support the Senate bill and we also support the House bill, with the exception of the moratorium. There are three reasons why I believe that the moratorium is not necessary.

First of all, there are the new SEC rules that are being aggressively enforced at this time. Second, California has adopted new rules and the California rules are being aggressively enforced, I can tell you from personal experience. And, third, in spite of what Mr. Jefferies said about the stock exchanges accepting abusive rollups for listing on the New York and the AMEX and the NASDAQ, today, those stock exchanges are asking us as general partners to not only clear in California, whether we have California investors or not. Even if we didn't have California investors, they are asking us to clear in California. And they are asking us to prove compliance with the Markey-Dodd bills that have not yet been passed. So in spite of the fact that you haven't passed legislation, the stock exchanges are enforcing it for you.

Senator DODD. That's what you call influence.

[Laughter.]

Mr. BARBO. A moratorium is unnecessary and it is also unwise. The reason that a moratorium would not be wise at this time, is, if a company complies with the rules at the SEC and in California and the proposed legislation, they should be able to go forward in order to take advantage of the favorable market that exists.

I know the House bill has some language in there that allows the SEC to exempt people. The SEC has told me that it is not impos-

sible for them to do so, but it might be difficult since they really don't know what those issues are going to be.

I think it would be horribly ironic if today's limited partners were to be denied access to liquidity in this kind of a market by legislation that it's attempting to help them.

Thank you very much.

Senator DODD. Thank you very much, Mr. Barbo.

Mr. Cottone, we thank you for being here. You've very knowledgeable in this area. You're chairman of NASD, of course, the Director Participation Program Committee.

We thank you for being here.

STATEMENT OF PHILIP COTTONE, CHAIRMAN, NASD—DIRECT PARTICIPATION PROGRAMS COMMITTEE, WASHINGTON, DC

Mr. COTTONE. Thank you very much, Mr. Chairman, Senator Gramm.

I was the 1991 and 1992 chairman of the National Association of Securities Dealers, Director Participation Programs Committee, which developed the NASD's rules on rollups. Until January of this year, I was also vice chairman of the NASD board of governors. I'm pleased to have this opportunity to appear before you to discuss the regulation of limited partnership rollups.

We applaud your concern with the important problems that abusive rollups can present to the investing public. We're also greatly concerned with these problems and have taken a number of steps to halt these abuses.

We believe that rollups that are fairly done can provide important liquidity and economies of scales to partnerships in these economically troubled times. While the abuses must be and are being stopped, rollups can play a useful role for investors and business.

The NASD has adopted and filed with the SEC a comprehensive set of rules that should eliminate the past abuses of rollup transactions and assure their fairness in the future. These regulations were developed pursuant to the legislative initiatives taken in the 102nd Congress, and the letter received from you, Chairman Dodd, and 17 other Senators on October 8, 1992, expressing support for the quick passage of our rules.

Indeed, within 6 weeks of the letter, my DPP committee and the board of governors of the NASD developed and approved the rule changes that are currently on file.

When you opened the session, Mr. Chairman, you asked as the first question, do the rules adequately protect investors? Do they adequately address the abuses? And I can answer that, yes, they do. The pending rules on file with the SEC, we believe, fully eliminate the abuses that have taken place in the past.

I will point out also that several commentators have spoken favorably about the California rules, and what California did, by and large, is adopt our rules, so that California, and the commentators that have commented favorably on the California rules, also seem to believe that the rules are adequate.

But you then asked as a second question, are there gaps? And yes, there are because our regulations apply only to our members. And we're supportive of legislation that would apply these protec-

tions to those rollups where an NASD member is not involved and where the surviving entity does not list on our market.

Large nationwide rollups of partnerships are difficult to accomplish without the use of NASD members. However, smaller rollups, with a limited number of partnerships, can and have been solicited without our members and are not therefore covered by our rules.

Passage by Congress of legislation that mirrors our rules will assure a uniform standard for NASD members and nonmembers alike. And moreover, this legislation will provide uniformity for the listing of rollup securities on the major market. That was your last question. Do we want uniformity? Yes, we do want uniformity.

My written testimony, which I ask be made part of the record, describes the role of the NASD in working with Congress to curb rollup abuses starting in 1990.

In April of 1991, I chaired a special rollup committee consisting of experts representing limited partners, general partners, and NASD members. That subcommittee developed the rule changes and regulatory improvements noted in my written testimony. I will not review that now in any detail because it is in the written record. But I believe it is important here to address briefly the differences between our rules and your proposed bill, S. 424.

Our rules are based upon the provisions of the previously proposed legislation and seek to address the past rollup abuses and the areas of concern that were delineated in those bills.

Consequently, our rules do not differ greatly at all from the provisions of S. 424. One difference relates to the same security concept that your bill incorporates as an exclusion from the definition of a rollup. Each investor is provided an option to receive or retain a security under substantially the same terms and conditions. This transaction is not a rollup under your bill and we support this exclusion from the definition of a rollup.

In addition, however, our rules also use this same security concept with respect to dissenters' rights. The principle in each case is identical, whether the same security is used for the entire class, in which case the rollups is excluded from the bill, or just for dissenters, in which case we believe it should be available as compensation.

Second, NASD rules excluded from the definition of rollup, a situation where an independent, nonaffiliated third party proposes to take over the partnership from the existing general partner or sponsor. The conditions to this exclusion are that the transaction must be approved by two-thirds of the limiteds and the existing general partners may not receive any compensation other than what they're entitled to under the pre-existing partnership agreement.

The NASD feels that a transaction of this type, which is structured in many ways like a tender offer, does not contain the potential for abuse that the rules were designed to protect against.

And third, and Mr. Peabody will be glad to hear this, the NASD rules exclude from the rollup definition any reorganization of limited partnerships that, by the terms of the pre-existing partnership agreement, provide that the interests of the limited partners may be repurchased, recalled, or exchanged for registered securities in an operating company that was specifically identified at the time

of the formation of the original limited partnership. It appears this exclusion would apply to Houston Biotech, even though I haven't read Houston Biotech.

Such partnerships with a pre-existing agreement would include, for example, limited partnerships established solely for the purpose of conducting research and development, which were always intended to be merged with a parent and are usually not available to the retail public. We don't believe these are the types of transactions where abuses have been reported, again, as Mr. Peabody noted.

Last, an apparent difference between S. 424 and the NASD regulations is no difference at all, and it relates to the use of other rights in the bill in lieu of appraisal and compensation.

The NASD rules call for other comparable rights, which really should be considered as a further definition of other rights. Other comparable rights in our rules include approval by 75 percent of the limiteds, review by an independent committee, and other comparable rights which are noted in my written testimony.

In conclusion, the NASD believes that its proposed rules, if approved by the SEC, will appropriate regulate activities in connection with rollups and protect limited partners from the abuses that have occurred in the past. They are patterned on the principles set forth in the Senate bill and are consistent with the protection that bill seeks to bring about.

NASD regulations apply only to our members, however, and we support legislation that would apply these protections to those rollups where an NASD member is not involved and where the surviving entity did not list in our market.

Thank you very much.

Senator DODD. Thank you very much, and thanks for your help, by the way, in the past. We appreciate it.

Barry Guthary has been before us in the past, and we thank him for being here again. He's president of the North American Securities Administrators Association, from Boston, MA.

STATEMENT OF BARRY GUTHARY, PRESIDENT, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, BOSTON, MA

Mr. GUTHARY. Thank you, Mr. Chairman, members of the subcommittee.

My name is Barry Guthary, and I'm director of the Massachusetts Secretary of State's division of securities and currently serve as president of the North American Securities Administrators Association. On behalf of NASAA, I appreciate the opportunity to appear before you today to testify in support of S. 424, the Limited Partnership Rollup Reform Act of 1993.

Before getting into the specifics of NASAA's support for the pending legislation, I would like to take this opportunity to commend you, Mr. Chairman, and other members of this subcommittee for your unwavering commitment to the protection of rights and interests of small investors.

In testimony before this subcommittee in 1991, my colleague, Arizona securities division director, Dee Harris, recognized that it was the extentive review conducted by you and your staff which re-

sulted in the broad exposure of extremely serious investor protection issues that arise in connection with limited partnership rollups.

Regrettably, and despite your considerable efforts to the contrary, limited partners today still lack protection against abusive rollup transactions. And that's what I would like to turn to because NASAA believes, as we testified before the House, that the current activities by the regulatory agencies—that is, in California, by the SEC and by the NASD—still provide gaps that would allow abusive rollups to take place.

First of all, the SEC. Though we commend the SEC for revising its proxy and disclosure rules, the SEC faces an insurmountable problem here, and that is, no revisions to the proxy rules would change the relationship between the general partner and the limited partner in terms of the overwhelming power of the general partner to control a proxy contest.

The very nature of limited partnerships of the type that we seek to regulate here involve almost no institutional investors. Most of them have no one with investments over $40,000 or $50,000, and it just is not feasible for any one of them to mount a campaign against a general partner.

The general partner, on the other hand, often has the resources of the fund itself—indeed, that's one of the abuses that we would like corrected—to engage in a proxy contest.

One of the, I think, my disagreements with Senator Gramm would be on the contract theory as exactly in this area. Where the proxy contest is a fair contest, I would say contractual rights would be very meaningful. But I think in this case, it's a theoretical concept.

We held hearings in Massachusetts and in hearings before the House and the Senate here, we have been told of the boiler-room tactics basically pursued by solicitation firms. Though these firms are not registered with the NASD, they're perfectly legal. They're out there and, for a fee, they will solicit votes for you. And for a larger fee, they will solicit only the votes you want obtained.

Mr. Nelson commented that he had voted and he got three calls trying to change his mind. One case we have in Massachusetts is an 85-year-old woman who was called 7 or 8 times in a row at 10 or 11 at night, beating her into it. She tried to vote no because her son is a financial planner and had told her to vote no and they literally would not permit her to vote no.

These are literally the tactics, as I said, pursued by the pennystock dealers and others, and because the general partner controls them, it gives them an overwhelming force in a proxy contest.

Turning to the NASD, as Mr. Cottone said, the major out of the NASD rules is it doesn't affect nonmembers. And as Mr. Jefferies pointed out, it is perfectly possible—and I would disagree that it's the smaller partnerships. I think any partnership in America now can hire a non-NASD appraisal firm, or perhaps even an NASD member to do the appraisal, but that's their only limited involved.

That's not clear as to whether that constitutes participation. But if the NASD takes that, so much the better. But they still can hire

independent accountants, independent appraisers, and use proxy solicitation firms and not have to use an NASD member.

Also, though the California rules are modelled perhaps on the NASD rule, there's a fundamental difference, and that is the fairness opinion.

As far as the California legislation goes, it has been pointed out that California is only one State. Second, thought we have not gone into it, there are legal devices that make the California process questionable. I know in Massachusetts, 4 or 5 years ago, though it was not exactly a rollup situation, it was a merger situation where, because the issuer did not meet the exemption under Massachusetts blue sky law, they were forced to register.

They basically, because they did not want to register, they came to us—they put all of the interests in trust in New York City and basically conducted the campaign, claiming the Massachusetts people, when and if they reach New York City, could collect their interest, and though they allowed them to vote, they never registered the security in Massachusetts.

We didn't pursue this because the Massachusetts citizens sued and they settled out. As to whether that's legal, I don't know, but there are at least counsel out there who are telling issuers how to end-run a particular state's action.

That leads me to your second point, and that is, will these significantly reduced rollup transactions? I think several people have commented today that it will not. I think one of the most telling pieces of commentary today was Mr. Bridges, when he said that there were no dissenters in the Kelley Oil.

That is the whole point of dissenters' rights. The fixating on dissenters' rights is a technique to produce a fairer rollup transaction. And though there might be other ways to do this, I think the authors of the bill recognize that this is the one way to make the general partner give a fairer deal to the limited partners to induce them to vote favorably. It is not concentrated on giving one or two people the right to stop the partnership. Again, in the Houston Biotech deal, there were very few dissenters. I think the fairer the deal, you'll find, the fewer the dissenters there.

One last comments about one of the outs that several people have asked for, and that's the so-called independent, third-party out.

NASAA is very much against this because I think the history of rollups suggests that the independent third-party out simply does not work. The problem is that you do not develop a true arm's-length transaction.

The Hallwood transactions were all so-called independent, third-party movement. Basically, what that does is that the independent third party buys off the general partner. They simply give the general partner, who is the only person negotiating on behalf of the individual partners at all, individual limited partners, it buys them out and they no longer protect the individual partners and they're left alone, which also turns to a feature that NASAA would strongly recommend be included in the Senate, and that is the requirement of fairness opinion.

The principal issue in the fairness opinion is really bringing in a third party. The purpose of this third party is, in a sense, to

allow someone to represent the limited partnership's interest, because in these transactions, no one represents that interest.

NASAA believes that by requiring a fairness opinion, you will, in a sense, have an appraiser standing in to protect fairness to the limited partners.

Thank you.

Senator DODD. Thank you very much. My colleague from Missouri, I apologize, Kit, for not interrupting our witnesses. Any comments you would like to make?

OPENING COMMENTS OF SENATOR CHRISTOPHER S. BOND

Senator BOND. No. I apologize for being late. We had another hearing that I had to attend.

Mr. Chairman, as you know, and I'll advise the witnesses, I'm a strong supporter of S. 424. My State of Missouri has about 163,000 limited partners. They're about an average of $10,000 each.

We've heard many tales of horror stories from them. We value the testimony here today to try to lead us to the best way to solve these problems.

I look forward to going through the rest of the testimony and I may have a couple of questions.

Thank you, Mr. Chairman.

Senator DODD. Thank you. I'd like to place in the record at the outset of the hearing, the statements of myself and Senator Gramm, a statement by Senator D'Amato, who, unfortunately, cannot be with us today, either.

Well, this has been excellent. Your testimony has been very helpful, very knowledgeable. I don't have a lot of questions for you.

Mr. Garday, just on a point, I sort of interrupted you and I apologize, in the midst of your testimony. You suggested that, in fact, as a result of even having this pending legislation, that there had been, you perceived, far less abuses occurring as a result of the level of activity that's occurred in both the House and Senate, with the passage of the Senate bill a year ago.

My concern would be, and the question I'd raise to you is one that seems fairly obvious. If we were now, after all of this activity, to back away and do nothing, would we run the risk of having exactly the same level of activity return that you suggest in your testimony, dissipated as a result of the level of activity that's occurring in Congress and the SEC?

Mr. GARDAY. Well, that's three or four questions in one, but I'll answer the best way I can.

As it relates to the industry that I represent, and that is, public companies that are already subject to filing with the Securities and Exchange Commission and subject to filings with the NASD and, to some small extent, members of our industry are subject to filing in the various states—I apologize for the tear in my eye, Senator.

Senator DODD. I didn't want to bring you to tears on that.

[Laughter.]

Mr. GARDAY. As it relates to the cadre of companies in our industry, we're already highly regulated. The SEC regulation, in combination with the proposed regulation by the NASD, in our view, already protects the investor, whether that investor be a partner

who is in transition to becoming a shareholder, or whether that investor is already a shareholder.

We acknowledge, readily acknowledge, the abuses in the past including partnership rollups. But this committee and similar committees in the House have shined a great big spotlight on this entire problem.

The combination of that focus and the—we'll call it the more normal regulatory progress—in our view, at least, in the real estate segment, the only area that I consider myself expert, in our view, most of these abuses have stopped because the end result in this chain of events from becoming a partnership, public or private, to becoming a public corporation and undergoing all the scrutiny, is that the day those securities are listed on an exchange or traded, that day, the market will value them correctly.

The market is the market is the market. Some of these horror stories that we have heard and you have heard, where someone thinks they have a $10 share and 3 hours later, or 3 days later, on the exchange, that share is trading for $3, that's the market telling the investor and the general partner that they did it wrong.

What has happened in the continuum of going from a partnership entity to a corporate entity, when this first started out in the rollup situation, the general partners never checked with the market place. They abused, sorely abused, the limited partner investor and took it all away to the market and were surprised, I believe, that the market said, wait a minute. That's not $10 worth of equity. That's $3 worth of equity, or maybe even one dollar's worth of equity.

Now, because of all of the scrutiny and the spotlight shined by this committee and others, the general partners are checking with and, if you will, adhering to the rules. There are less abuses, in our opinion, and there is much less of a chance of some of these practices happening because the day these people become shareholders, they're going to be angry.

And what do you do when you're an angry shareholder of a public company? You sell. That's the discipline that I live with as the CEO of a public company. If I do something to anger my shareholders, or people who are entering my company as new shareholders, the next day, the day they get their certificate, they will take it to the window of Merrill Lynch or Paine Webber or Dean Witter, and they will sell. That's the ultimate discipline.

Senator DODD. Well, it occurred to me as I was listening to all of you, and I'd say this to Ms. Heyman, for instance, and others, we have some 58,000 limited partners in the State of Connecticut, a small State. Our job here is not to guarantee that if you make an investment, it's going to be a good one. All we can do is see to it that there are relative rules of fairness. And in fact, there will be a lot of these investments that you'll make, they'll sound terrific and they're going to go belly up. That's the nature of taking a risk in our economy.

So I wouldn't want to suggest, by any stretch of the imagination, that what we're trying to do here is somehow guarantee investors that, as a result of the passage of this legislation, you're never going to lose any money. Not at all.

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Let me ask, if I can, Mr. Guthary, and I'll just ask a couple of questions, then turn to my colleagues. On the pre-emption issue, I'm very much for trying to establish uniformity, and I think I suggested at the outset of my remarks that I thought that was an important question to be raised.

In the absence of us passing legislation here, I suspect you're going to see an explosion of State legislation. That would be my guess, anyway, in this area. From a business perspective, my hunch would be that would be exactly the opposite that business would want, that lack of uniformity and consistency. So I'm inclined to agree with the notion of pre-emption, if we can establish strong Federal legislation in this area. You disagree with that?

Mr. GUTHARY. Well, I don't disagree in the way you present it. I guess I would say it's not necessary at this time. I think the States, in a sense, will pre-empt themselves. Currently, California is the only State that has done anything and, as far as I know, from talking to NASAA members, it's the only State that has an active legislative issue before it.

I agree with you. If this year goes again without the bill being enacted, other States would follow. But I think Federal legislation will effectively stop any State movement because I think, as NASAA has recognized in the other States, it is very difficult to regulate these transactions.

The States can easily regulate an initial sale under a blue sky law. That is, prevent the relationship from ever forming. But once a national entity is formed where you have everyone in the 50 States having a similar relationship with the issuer, the States realize that you can't start then having A have a different relationship with B.

Senator DODD. Yes.

Mr. GUTHARY. I don't think the States would do that. So, in a sense, I guess if you're saying there should be national uniformity, I agree with you. I just don't think you need to have a pre-emptive measure.

I guess general NASAA, as I stated before, kind of disagrees with pre-emption in that we don't know what 10 years from now will bring us. If you pre-empt it and we have another—no one knew 10 years ago this was going to happen, or we could have tried to.

Senator DODD. Yes.

Mr. GUTHARY. It just prevents the State at a future time from moving. But, in a sense, it's just, as I say, not necessary. But certainly, NASAA endorses a national——

Senator DODD. Spoken like a true State administrator.

[Laughter.]

Mr. Cottone, Mr. Peabody raised a very good question, and I'd like you to address it, if you could. I'd ask anyone else who wants to comment on any of these things to do so. If you feel you want to pipe up on any of these questions, don't hesitate in doing so.

Mr. Peabody pointed out that one of the problems you run into potentially, and correct me if I'm wrong in this, Mr. Peabody, that if dissenters are allowed to pull out and be compensated in cash, then, in some circumstances, you could substantially deplete the capital necessary in these arrangements.

The Senate bill does not require cash compensation at all. It's similar to NASD's proposals in that regard, setting forth a series of alternative rights that are there for investors.

I wonder if you might discuss what some of those alternatives are and explain how the flexibility provided in the bill and in the NASD rules may address some of Mr. Peabody's very legitimate concerns.

Mr. COTTONE. Yes, Mr. Chairman. We are, of course, in agreement with the Senate's position on this matter, in that our rules require appraisal and compensation initially. But as an alternative to that, we permit the dissenters to be able to retain a security, similar to the exclusion in your bill that I mentioned in my oral testimony.

And then, third, we permit the general partner to make available other comparable rights. Those other comparable rights include 75 percent super majority approval by all the limited partners.

We feel if a proposal is made by the general partner and 75 percent of the limiteds are so smitten with it that they vote yes for it, that should be a comparable right such that it is permissible for the general partner to proceed.

Second, and very importantly, we permit the general partner to constitute an independent committee which is formed for the purpose of negotiating with the general partner and representing the interests of the limited partners. Something Mr. Guthary said isn't available in our rules really would be available.

This independent committee, we think, is an important way to develop alternatives to cash and other kinds of compensation where it might not be in the partnership's best interest for such payments to be made.

And then, third, if an independent committee, for whatever reason, isn't possible, we permit the ingenuity of the market place to work and permit other comparable rights to be developed and given to the dissenters that are acceptable to the NASD. If the NASD believes it's necessary, it can constitute an independent committee and set it up to negotiate with the general partner.

So, Senator Gramm, we believe in the free market acting, as well as you, and we think in our rules we've crafted a way for the general partner to be able to respond to the forces of the market and to be able to do what's in the best interests of the partnership and all the partners without the straitjacket that you don't want and we don't want them to have with a narrow, constraining bill or rule that requires them to do something that may not be in the partnership's best interest.

Senator DODD. And I thank you very much for that.

Mr. Jefferies, my last question to you, and you may have responded to this in your comments.

Senator Gramm has pointed out, his major point of contention is the sanctity of contract here. In our opening comments, I shared with him some of my thoughts on that particular point. I wonder if you might comment on this very legitimate question about the central point in his concern.

Mr. JEFFERIES. Right. Mr. Chairman, I agree with what Senator Gramm is saying. At least I understand the theory and the ideology behind it. I think we'd be in a different situation if these trans-

actions had indeed in any way been contemplated at the time the original offering was done. I think that would be a different situation. Also, if these were liquid investments, it would be a different situation.

And I also think it's wrong to allow something to occur simply because it's not expressly illegal. I guess while we banter about things on a matter of principle and so forth, investors in partnerships continue to be abused. That's the reality of the situation and it all boils down to the fact that I simply don't think, from my conversations with many, many limited partners who have contacted our firm, I simply don't believe these people even understand what they're voting for. I think that the people even voting for it that make up the majority, I believe they have no idea what they're voting for.

And if this was a transaction that had been in any way contemplated at the outset of the offering, which I think is the case with the transactions done by Kelley Oil in their exchange offers now, I believe those were contemplated at the time they're put together, that those will eventually be exchanged into the new company, and I think we'd be in a different situation.

Senator DODD. Mr. Goldberg, do you want to comment on this?

Mr. GOLDBERG. Actually, I do. I heard a remark recently at a meeting that took place in New York at a law firm where they were asked the question—why it was time to do rollups? I might add it was a very well attended meeting.

One of the investment bankers there discussed the issue as to litigation after these rollups actually take place. Obviously, if there are some wrongs here that took place in terms of their fiduciary responsibility under the contract of the partnership agreement, that that's provided for. We have a legal system to remedy these breaches of contract.

In fact, in all of the deals since 1987 that Dean Witter was involved in, that totals 23, there were lawsuits. They were class action lawsuits to defend the rights of the investors as to their rights under a contract. The success of those lawsuits were very poor. Because of the class action nature, the fact that—actually, there are a lot of problems with those class actions, too many to enumerate.

I think the issue really becomes one of focusing—it's wonderful today that everybody's focusing on why, I think the comment was made, you have a fiduciary responsibility as a general partner today to do a rollup, and never before.

I think it has a lot more to do with serving their own self-interests alongside the investors, but at times it is at the expense of their fiduciary responsibilities.

The limited partnership is the only investment that I'm aware of that you can go through a limited reorganization and not have Federal legislation mandating definitive standards of conduct. So, therefore, I think the issue of contract is a real one. There's no way for a limited partner to exercise his rights successfully, other than have the legislators protect him.

Senator DODD. Mr. Bridges, go ahead.

Mr. BRIDGES. If I may just add a comment.

In the case of our particular business plan, preservation of capital was very important to us from the beginning. Our business

happens to be one that, certainly during the last decade or so, capital has been very difficult to come by, and preserving it for the partnership was very important.

The issue of allowing those investors who chose to be active and to participate in the further development, and to risk their money, was extremely important.

I would like also just to say that I wouldn't want the general partner to be so separated from the limited partners that we lose sight of the fact that they are in fact all partners. While the general partner is the manager and is in ultimate responsibility and control of the partnership, the fact remains that, in these development programs in which investors chose to be active, about a third of the money was put up by those investors but two-thirds of the money on exactly the same basis was put up by the general partner.

And so, again, I would like to make sure that legislation, if that's the case, or regulation and rules, do not so separate the general partner, that the rights of both and the capital put up by both are not honored in that context.

Senator DODD. Could I ask you, by the way, Mr. Jefferies said he thought that the ultimate arrangement that occurred with Kelley Oil was contemplated at the time of the initial offering and that your limited partners had the opportunity to be available to that information. Is that true?

Mr. BRIDGES. That's true. To the extent permitted by the laws and the security regulations, the contemplation of the development of reserves by those partners who chose to be active and the subsequent exchange, at whatever value they generated, successful or not, as the future bore out, was the original idea for the acquisition and growth of the partnership with limited risk. It also was a means by which the reserve base of the partnership could be increased by the use of its own newly issued securities and therefore, continue to preserve the capital for the partners.

Senator DODD. But the point is there, it seems to me, in that arrangement, you felt it was pretty important that those original investors be aware of where this could go.

Mr. BRIDGES. Exactly.

Senator DODD. Let me ask you, just for the sake of discussion, let's assume that they had no idea whatsoever.

I guess the point here we're trying to drive at is whether or not those then limited partners should have some dissenters' rights, having all of a sudden entered into a specific investment relationship, that becomes something else without any contemplation or awareness of that at all. How do you feel about that?

Mr. BRIDGES. In our initial rollup, for example, Kelley Partners was itself formed by an exchange offer in 1986. But the programs were operated in joint venture or partnership format for some 15 or 18 years prior to that period of time. The formation of that publicly traded partnership by an exchange offer, I would doubt seriously was contemplated in the late 1960's and early 1970's, when we started these. It certainly seemed like an appropriate thing to do at the time though since a liquid security with immediate market value was achieved while, continuation of the development

rights and the basic business plan that we'd adopted for several years, were retained in the exchange offer.

I would like to say that the issue of dissenters' rights is one that's complicated. My point earlier was that while we have had few dissenters, that doesn't mean that there wouldn't be others. They represent very much the minority, and the exchange was a business plan, again, that was contemplated from the outset by not only the initial exchanges, but the subsequent people who have invested with us by choosing to be active in the development programs.

The California code, however, proposes a second appraisal. The issue is not that they aren't getting an appraisal, and it's not that it's not independent, it's a second appraisal after the first one is done. We believe the right to a second appraisal would be unnecessary under those circumstances and under the conditions of the original contemplation of a subsequent exchange offer.

The other thing is, with respect to fairness opinions, we've gotten fairness opinions on both sides of each of our exchanges. The independent appraisal is similar to, but perhaps a step from that. It's a slightly different issue.

Senator DODD. Yes. Thank you very much. I appreciate that.

Senator Gramm?

Senator GRAMM. Mr. Chairman, let me begin by thanking everybody for coming. We very much appreciate you taking your time to come and talk to us about this issue.

I think the quality of the presentations has been uniformly high. Thank you very much for caring enough about what is happening in your industry, no matter what role you played in it, to come and talk to us about it.

I'd like to make a few points and then ask a few questions.

First of all, our colleague from Washington State left, having made the very clever point about minority rights. Of course, if we had strict majority rule in the contract that governs our relationship under the Constitution, Bill Clinton wouldn't be President. We have a set of rules that the Founding Fathers passed down called the Constitution, and it sets out rights. When I came to the Senate, we had a set of rules, and those rules gave to members certain rights.

I think what this debate is about, at least in my mind, is the rights of people who are willing to put up their money.

The second point I'd like to make is this. In listening to several of your testimonies, I got the idea that you still envision these huge quantities of rollups occurring. The data I have says to me, that there have only been nine of them in the last 2 years, and that they've been basically noncontested.

So it would not be uncommon if we are doing our usual, namely closing the barn door long after there were no horses living in the barn. In fact, legislatively, that's almost the way we always work.

I don't believe any set of investment rules could have made an investment in the oil business safe in 1983. I don't think there's any set of rules we could have written, no minority rights that could have been enshrined in the law of the land, that could have made an investment in a drilling program in 1983 secure.

I think the problem is not that you ended up in a bad deal that was being rolled up and then, when it was put to the market test, showing what it was worth, it turned out not to be worth very much. I think the problem is that if some investment adviser told anybody that a joint venture in the oil business was not a very, very risky investment, then that is the person that we ought to be talking about here, not the mechanism whereby bad news was delivered.

I want to ask Mr. Barbo a question. But let me just go to the final point I wanted to make.

I don't know how, in a civilized society, we can decide after the fact, based on opinion, based on who cares enough to write their congressman, what a fair contract is. If we're going to do an opinion poll every day to determine which contracts are fair, if we're going to enforce the contract clause of the Constitution based on public opinion as to what a fair contract is, I don't know how we're going to run an organized society.

What we do, or at least what the system has been structured to do, is to enforce legal contracts. And the fact that people do not live up to contracts, it seems to me, is hardly a justification for invalidating them.

We have laws, we have courts to enforce contracts. They don't do it perfectly, but that is an inherent problem with trying to enforce a set of rights that exists. And I don't know of any law that we could pass that's going to change that.

Finally, with regard to anticipated changes, the whole purpose of the clause in a limited partnership or any other agreement that empowers a group to make decisions, is that things do change. There are tremendous uncertainties in the world we live in. What we have to do is to try to respond to those changes when they occur.

So those are my general comments. I'd like to pose a couple of questions to Mr. Barbo.

Mr. Barbo said that, or I think you said, Mr. Barbo, that you had gone through the process of a rollup under the provisions of this bill. But it seems to me, you've done it under the provisions of the SEC regulations and under the provisions of the National Association of Securities Dealers. But am I wrong that we're not enforcing the minority rights provisions of this bill under existing regulations, or are we?

Mr. BARBO. You are. I'm not a lawyer. Some of these kinds of questions I would ask my legal counsel to answer.

And thank heavens for you, he's not here because he would answer them.

Senator GRAMM. Let me ask that question to Mr. Cottone.

Mr. BARBO. Well, let me finish the answer first.

Senator GRAMM. OK.

Mr. BARBO. You're correct that those provisions are there. However, part of it is a function of the fact that there is anticipated pending Federal legislation. Not only are the SEC regulations requiring those kinds of dissenter rights, and the State of California requiring those kinds of dissenter rights, but the stock exchanges are de facto requiring us to comply with yet enacted Federal legislation.

So, at this time the requirement of offering dissenter's rights is in place. If the Congress doesn't act on this, then I don't know exactly what the SEC or the exchanges would do but California would still require dissenter's rights.

Mr. COTTONE. Senator, the bulk of our rules are not in effect. They are before the SEC awaiting approval right now. There are some rules that we adopted earlier with respect to differential compensation and listing standards that are in effect. But the rules that I was discussing with respect to compensation and dissenting shareholders, they are not in effect.

Senator GRAMM. Let me go back, Mr. Barbo, and pose another question.

One of the things that I hadn't heard discussed here is the following situation that at least I can envision. You can tell me whether I'm talking about an empty set and whether this is a legitimate concern.

Let's say you have a group of investors who had entered into an agreement whereby the majority of the limited partners could make a decision concerning the investment. Let's say now, after the fact, we come in and empower a minority of the limited partners to have certain protections. Are you worried that this could create a possibility where it would be much harder to build a consensus if a few minority members could disrupt the decision of the majority? Would you be concerned that perhaps you might get into a situation where the majority would have to try to buy out the minority in order to protect their investment, and that you might actually get predatory behavior by a minority under that circumstance? Or might you have people who wanted to force a limited partnership in one direction come in and buy out minority members at a premium and then, as minority members themselves, exercise a right? Is that a concern or am I just dreaming that?

Mr. BARBO. Yes, I think it is a concern. However the majority will still rule. The way we are handling that concern is that we are offering the minority rights provision, dissenters' rights, to everybody, whether they vote yes or no.

But I can conceive of a situation where, the granting of minority rights could make it more difficult for the majority to act.

Senator GRAMM. Well, let's say——

Senator DODD. Ms. Heyman and Mr. Nelson, they don't look like predators to me. I don't know.

Senator GRAMM. OK.

[Laughter.]

The point is that when you create rights, you alter behavior. Let me go back to my point. Let me take the question one step further.

Let's say that you had a partnership interest that you had bought for $50,000. And let's say the market value, if you went out and sold it later, was $10,000. So people are obviously hurt. And let's say you thought that, by rolling it up, you could get $14,000. Obviously, people are going to be very unhappy with the $14,000. Would it not be possible that a small number of the investors could say, well, if in fact the majority is correct that there is $14,000 in this investment if we roll it up rather than $10,000 if we don't, and if, as a minority, we could block that transaction, that there is maybe an economic rent of $4,000 per investor. We might be able,

they say, to extract part of that from everybody else by simply saying that we will oppose it and fight it, that we might be able in fact to get them to pay us $2,000 per interest, because it is still worth it to them if they can roll it up and actually get $14,000, instead of the $10,000. Is that far-fetched? Is that possible?

Mr. BARBO. Well, I suppose it's within the realm of possibility. But I'm not sure it's in the realm of practicality. The minority could not talk the majority into paying the minority more than the interest is worth.

The thing that I'm more concerned about is what's going on in my situation right today. I have not done the rollup yet. I'm in the middle of registration with the SEC. I cannot discuss things with my limited partners, I cannot write them a letter and explain the transition to them. They're scared because of all of these abuses that have taken place in the past.

I got a telephone call from an investor who, in 1981, invested $50,000 with us. They are currently earning about 11 percent cash on their investment. One of these predatory funds out there that's trying to acquire limited partnership interest, went to the SEC, got a hold of my securities offering, and therefore knows how many shares of stock we're going to be offering that person, and went out and talked to this person and offered them $30,000 for their investment.

The predator is fully informed. The limited partner is not fully informed because I can't discuss it with him. And using these scare tactics like, well, the first thing that's going to happen to your investment is it's going to drop 30 percent the first day it opens. That, to me, is predatory.

Senator GRAMM. So you've got two options. One is to sell to this predator fund. The other is to roll up. And you're saying that the predator fund is going to minority holders.

Mr. BARBO. They're going to uninformed limited partners because we haven't sent them this big, thick prospectus. And we can't send them a little article.

Senator GRAMM. But what if we passed a law that, sure enough, let a minority of your investors stop the deal? Wouldn't you believe people are doing it now where you're simply granting these minority rights. It's not written into your contract. What if it were the law of the land? Do you think that would happen more often?

Mr. BARBO. Well—if you have dissenters' rights in the proposals that you're making, it would still require a majority to stop it. In other words, the majority can still vote in favor of it. You just have to then grant the dissenting people some options, other than taking the shares of stock.

So, in any event——

Senator GRAMM. Are those options free?

Mr. BARBO. No, but they shouldn't be. As I understand them, cash is one, which it would be difficult for some people to do. Notes of an equal value of the appraised value of the underlying assets is an acceptable form of dissenters' compensation, and that's what we're offering. I had all the assets appraised, offering notes for that amount at an interest rate that would not cause them to trade at a discount, and offering those not only to dissenters, but to everybody.

Senator GRAMM. Let me turn to Mr. Nelson now, as one of my constituents who made these investments.

Mr. Nelson, looking back at the investment in 1983 in the drilling program, a limited partner——

Mr. NELSON. No, sir, it was not a drilling program. It was buying production.

Senator GRAMM. Buying production.

Mr. NELSON. And it got rolled in with others that were drilling programs.

Senator GRAMM. And, of course, during the early 1980's, we had the boom times in Texas. Oil prices were up $30 a barrel, projected in some quarters over $40.

Mr. NELSON. We did some projections.

Senator GRAMM. Fell down to $10 a barrel. Do you believe that the decline in value was due to the rollup or due to the underlying change in the price of the production?

Mr. NELSON. Well, I'm sure the drop in value was due to the underlying change in the price of oil and gas. But what they did is they rolled it into drilling funds, which were going broke. And I think as a production fund, they could have survived. So what they had done is dropped the value even more than it would have if it had survived as a production fund.

Senator GRAMM. And the majority of the members voted to do that?

Mr. NELSON. I don't know. I assume they did because it was done. I have no way of knowing what went on in the accounting room.

Senator GRAMM. Anybody else want to comment on the question I raised about concern about creating rights of minority investors? Mr. Peabody?

Mr. PEABODY. Yes, sir, Senator Gramm.

Any time that you use a super-majority provision, whether it's a corporation—we use these vehicles all the time in venture capital types of deals—you're creating disproportionate types of representation. Sometimes it works and sometimes it doesn't. But it's a double-edge sword because if you don't like what's going on, you can vote against it. You can stop it. You can block it. But, on the other hand, there's another 65 or 70 percent of the people out there that might like it, and reasonable people can differ on these issues.

In the case of an R&D partnership, the R&D partnership is organized for one reason, and that is to spend money on research and development. Now, suppose I'm part of a majority in the partnership. I think there's going to be $8 million in cash in the rolled up entity when I vote in favor of rolling up the partnership. Let's say the partnership gets a 30 percent minority vote and has to cash out 30 percent of the $8 million.

Now, if what the partnership is doing is researching or doing clinical trials, the risk associated with a majority investment, with a majority vote in favor of an $8 million corpus versus a $5 million corpus, it's quite different. That's the risk that you run in this kind of a situation.

So you have to be careful to differentiate as between situations. In an income-producing partnership——

Senator DODD. You know we don't require cash-out in our bill.

Mr. PEABODY. But there are only two kinds of compensation in this kind of a deal, really. It's common stock or cash. I don't know what else you'd give them.

Senator GRAMM. Well, let me go back to the point.

When you, as the largest investor in this agreement, and I don't know what your agreement is, but let me just say, hypothetically, let's say it is an agreement where the majority of the share-owners, or the majority of the minority partners can vote and make a decision.

Do you feel that it would lower the value of your investment if the Government came in and empowered a minority to have rights that you didn't agree to?

Mr. PEABODY. I think it's possible, certainly. The Government has lowered the value of this investment by $1.5 million. That's what we spent on complying with the regulation.

We filed probably in the last 3 or 4 years, 10,000 pages. This is a company with 38 people. 10,000 pages with the SEC. Now, I challenge anyone to figure out what you can say about a company with 38 people that needs 10,000 pages.

Senator GRAMM. Well, Mr. Chairman, I don't want to belabor the obvious here, but I see two problems, and I will just raise them and leave them.

First of all, there's no doubt about the fact that there have been bad actors in this process and that people have been abused by general partners who are looking after their interests and not the interest of the investment.

Limited partnerships are risky investments. They are by their nature risky investments. I think the question we've got to ask is, by requiring all of these regulations to try to protect against people who may have tried to mislead in a way that they are no longer legally able to do what are we paying for that? What are we paying for it in terms of regulatory costs, the burden on capital creation and research and economic growth? And what are we paying for it in terms of the ability to get people to put money into limited partnerships?

I can only speak for myself. I would be very loathe to invest money in a general partnership if I didn't think that the majority could make a decision or if you empowered a minority. I would view that as something that could potentially be negative, depending on whether I'm in the majority or the minority. If I were an owner, current owner of part of a limited partnership, I would view changing the rules of the game as a very real peril.

And then finally is the point, how dangerous is it in our society to have the government invalidating contracts? As a principle, maybe here the benefits are worth it, but is it a principle that we want to see replicated in other areas?

Maybe we should look at the case of common stock. There are some people who really don't understand that stock prices can go down. And maybe we should come in, even though people had the prospectus, even though they should have known, maybe we ought to create new rights with regard to common stocks.

These are the concerns that I have. Maybe for this day and this issue, they don't sound big, but in the big picture, I think they are

very big. And that's why I have seen this as such a major issue, whereas, obviously, to many, it is an irrelevant issue.

Mr. Chairman, again, thank you.

Senator DODD. Not at all, and thank you, Senator Gramm.

Let me just echo Senator Gramm's comments that he made at the outset. I think it's been very, very helpful today. And where these hearings can be tedious, it's extremely worthwhile to hear people who every day are doing these things.

We're here in a legislative capacity and get involved in these issues on occasion. Those of you out here are in the business every single day, are dealing with these issues every single day.

I think it's extremely worthwhile for us to hear from people like yourselves. So I'm very grateful to all of you. I'm particularly grateful to you, Mrs. Heyman and Mr. Nelson, as well. It's not easy to come and talk about your experience. As you say, Mrs. Heyman, you had a master's degree, and to stand up and say, maybe I should have known better is not easy. You're not alone in this at all, and there are people who are very professional people who would like to pretend that they understand everything in that 180 pages, whatever it is that you're holding there, and they don't understand any more than you do. They just pretend they do. And you've got courage to come forward and say so.

Senator GRAMM. And might I add, as a person who has a PhD in economics, I have bought into lots of bad deals.

[Laughter.]

I probably would do some more if I weren't now investing almost exclusively in groceries and college tuition.

[Laughter.]

Senator DODD. But the point here, I think, is extremely worthwhile. In the last 12 years, I guess going on 13 years now, some 11 to 15 million Americans have invested somewhere between $150 and $200 billion in limited partnerships. They are extremely worthwhile. It's a tremendous opportunity for a smaller investor. The average investment is around $8,000 to $10,000. In my State, it's around $11,000. The national average is right around $10,000.

One of the things I hope we do, I think one of the roles of this committee is to inject as much confidence, investor confidence, as possible in the market place.

The questions raised by Senator Gramm are not illegitimate and they're not small. They're very central questions. But how do we go about the business of trying to see to it that people out there, for their own individual needs, decide that they want to make some investments for education of their families or whatever other purpose, has a degree of confidence, not that they're necessarily going to get the return on that investment, but that it will be a fair process that goes forward.

And it's extremely important that small investors in this country have that sense of confidence about the process, about the game.

I don't think there are many people who believe that, necessarily, no matter how much hype there is, about what a solid investment this is in 20 years of experience and the average rates of return are 10 or 11 or 12 percent, most people know that's part of the salesmanship here.

What they're not expecting to have happen is that the process, the rules are going to necessarily disadvantage them substantially.

If the perception becomes that those rules are not fair, that equity does not play an important role even in all of this, then my concern would be that you'd see a tremendous retreat on the part of those 11 or 12 million people that play a critical role in providing the capital that is necessary for the research, for the other needs that we have economically in the country.

We need to keep those people engaged and involved in this process, even when they take losses and so forth on those questions.

So I don't minimize the important questions being raised here, but the central question, it seems to me, is to maintain that high level of investor confidence that the process is a fair process for them. And obviously, we've got to make sure when we do that, that the majority of those investors believe it's a fair process and that the managing or general partners can have some degree of confidence that when they have the dollars, they can do certain things. All of those elements have to be a part of that.

But this has been very helpful, and we thank you for being here. There may be some additional questions from other members and if there are, we'll submit them to you and ask you to get back to us as soon as you can.

The subcommittee will stand adjourned until further call of the Chair. Thank you.

[Whereupon, at 4:45 p.m., the subcommittee was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR JIM SASSER

Thank you Mr. Chairman for calling this hearing this afternoon. I appreciate the opportunity to hear from the distinguished panel of witnesses on the issue of limited partnership rollups.

In the last Congress, the Senate overwhelmingly passed legislation to reform the practice of limited partnership rollups. Mr. Chairman, you have introduced this same legislation this year, The Limited Partnership Rollup Reform Act of 1993, S. 424, and I am pleased to be a cosponsor.

This legislation is important to protecting investors from abuses that have occurred in the practice of converting limited partnerships into publicly traded corporations, known as a "Rollup."

Limited partners, who are generally small investors, are losing their life savings in these deals while general partners are reaping the benefits. In the major rollup transactions over the past several years, on average, limited partners have realized a drop of 45 percent from the initial offering price on the first day of trading in their newly issued rollup securities.

The need for legislation is clear and S. 424 provides the necessary safeguards against abuses. Rather than prohibit the practice of rollups, the legislation provides a framework under which limited partners can make an informed decision about a proposed rollup.

In particular, the bill provides limited partners with the right to communicate among themselves; facilitates communication among security holders; prohibits differential compensation for solicitation of "yes" votes; requires clear, concise disclosure in solicitations sent to investors; and provides security holders with a minimum offering period of 60 days to review a rollup.

I look forward to hearing from the witnesses on the practice of limited partnership rollups and hearing their views on the legislation.

Thank you Mr. Chairman.

PREPARED STATEMENT OF SENATOR ALFONSE M. D'AMATO

Mr. Chairman, I commend you for convening this hearing to examine the "Limited Partnership Rollup Reform Act." I would particularly like to welcome the witnesses from my home state of New York, Estelle and Robert Heyman.

I am concerned about the abuses that have occurred in limited partnership rollup transactions. In the last few years, this subcommittee has heard ample testimony from investors who were limited partners and whose interests were basically rolled over in a rollup transaction.

There are almost three quarters of a million limited partners in New York. As Mr. and Mrs. Heyman will tell us today, these limited partners face the possibility of having their original investment in a partnership rolled up into a wholly different investment vehicle.

A limited partnership rollup transforms the original limited partnership—an investment with a finite term and periodic returns into a publicly traded security—an investment with an infinite term and where returns are generally reinvested.

Many investors have lost a substantial portion of their original investment when their limited partnership interest was pooled with other limited partnerships or rolled up into new, publicly-traded securities. The "Limited Partnership Rollup Reform Act of 1993" addresses abuses in these rollup transactions.

This bill passed the Senate last Congress with overwhelming support but it has not yet become law. Although the NASD, the SEC and the State of California have since then taken steps to correct abuses in limited partnership rollup transactions, these steps do not solve the entire problem. The initiatives of the NASD and SEC are a piecemeal solution to the rollup problems and would only protect some investors.

Congress should pass legislation that protects all investors in limited partnerships. The "Limited Partnership Rollup Reform Act of 1993" accomplishes this. It encourages investors to communicate about the rollup and it requires clear, concise, and comprehensible disclosure documents so that investors can understand the proposed transaction. The bill also requires that there be sufficient time for limited partners to consider the rollup and requires national securities exchanges to adopt listing standards to protect these limited partners in the resulting rollup.

Rather than lull the investing public into thinking that what has already been done is enough, Congress should act to pass this legislation to ensure that limited partners receive adequate disclosure and are accorded fair treatment in the event of a rollup.

Thank you, Mr. Chairman.

TESTIMONY OF ESTELLE HEYMAN

APRIL 20, 1993

Good Afternoon. My name is Estelle Heyman. I am a New York City teacher. I am here today with my husband Robert, who is a Guidance Counselor also in New York City. I would like to mention that we both hold Master Degrees, because I am a little embarrassed by the events I am about to relate to you. I think we could basically be considered unsophisticated investors who were trying to make an intelligent decision by diversifying our investments. With our backgrounds we should have been able to understand what was happening to us in the roll-up of our Limited Partnership and to have had some control over the disastrous outcome. Since we still own other Limited Partnerships we are very concerned about the future of legislation regarding Limited Partnerships.

In 1983 we were advised by a stock broker at E.F. Hutton to buy a Limited Partnership called Hutton/Apache Energy Income Fund L.P. We wanted an investment that would help us finance our daughters' college tuition. This investment was to be low risk with an anticipated life of 7 years. The objective was never realized because in 1990 Hutton/Apache Energy Fund was involved in a roll-up. At that time we didn't even know what a roll-up entailed. The first time we realized that there was going to be a change was when we received a Prospectus/Proxy from Hallwood Energy Partners L.P. It contained approximately 150 pages of charts and explanations about an EDP merger. It was filled with complicated and almost indecipherable terminology such as selected historical and proforma financial information, the method of determining conversion ratio, consolidated statements of cash flow and operations, etc. Although my husband and I had taken Economics 101 sometime back in our college days, we honestly could not understand too much more than the fact that Hutton/Apache would now be Hallwood Energy Partners L.P. We received a letter of transmittal. It seemed a fait accompli. We were asked to submit our shares of Hutton/Apache Energy Fund, which had cost us $5,000, and in return we would receive 53 units of Hallwood Energy Partners L.P., now valued at $490. Believe me! Now we understood what had happened. We felt that we had been taken.

I feel that if S. 424 had been law at the time of this roll-up we would have been in a position to understand what was happening to our investment. The General Partners had the complete advantage. As a Limited Partner we were the ones who were not properly informed. S. 424 would have made it possible for the Limited Partners to have communicated with each other to discuss the roll-up. There would have been alternatives offered for dissenting limited partners and restrictions on the fees and commissions paid in the roll-up. In the Hallwood roll-up the cost was an unbelievable $10 million. The differences between the partnership and the new entity would have been clearly and prominently explained by comparisons, with fuller disclosure. It would have been understood that the anticipated life now changed from 7 years to 50 years, that a lower risk original investment had now become a high risk investment allowing for exploration and development; that net cash flow would no longer be required to be distributed, but could now be reinvested; and that now a two-third vote would be needed to remove the general partners instead of the original 50 percent vote. As your can see, we certainly would have been in a much better position if S. 424 had been law at the time of this roll-up.

We are now left with an investment that has gone from a value of $5,000 in 1983 to a disastrous $490 today. We did not have the money that we anticipated would help pay our daughters' college tuition and had to take a loan. With the anticipated life of the original investment now changed from 7 years to 50 years, that's 2035, this investment won't even help us in retirement.

The last point that I feel is very important is the need for dissenters' rights or other alternatives. The rules of fair practice in S. 424 are needed for the protection of the investors. The full disclosure should be concise with understandable terms that clearly compare the objectives and current status of all partnerships involved in the roll-up. The S.E.C. should be commended for their rules in this area. Hopefully, with a provided list of other shareholders, it would be possible to speak to other limited partners and make an intelligent and discriminating decision without feeling that you, as a limited partners, were being "steamrolled" into a vote that could affect your investment for the rest of your life.

Unfortunately we own other Limited Partnerships. I urge you to protect our investment and the investments of other unsuspecting investors whose limited partnerships have not yet been threatened by these unfair practices. Please safeguard our partnership rights by enacting S. 424, the Limited Partnership Roll-Up Reform Act of 1993.

PREPARED REMARKS OF J. ROBERT NELSON

Thank you Mr. Chairman. In Dallas, Texas, I retired in 1987 after 22 years with a family owned oil and gas company.

I am here to ask for your support of the bill to reform limited partnership rollups, S. 424.

Working with a financial adviser during the early to mid-1980's, and with an eye toward retirement in 7 to 10 years, I invested in 7 limited partnerships, 5 in real estate, 1 in oil & gas and 1 in merchandising. While they have all suffered, only two have been subject to rollups.

In 1982, I invested $15,000 in an oil & gas partnership called NRH 83D income fund. For the next couple of years the return on this investment was acceptable, but in 1985 this fund was combined with other NRM operated funds and became a stock company listed on the American Stock Exchange as NRM Energy Company Ltd. I received 98 shares in this new company which were worth approximately $6,000. Immediately after becoming a stock company distributions continued but within a year had dropped 90 percent and within 3 years had stopped. In 1989, the company was merged with another of their's called Edisto Resources. In 1991, Edisto offered to buy my 47 shares for $119 and with no brokerage fee I jumped at the offer. At least I got out before Edisto declared bankruptcy.

In 1986, I invested $5,000 in the Concord Milestone Income Fund, L.P., primarily because it was not a "leveraged" real estate partnership and had some tax advantages. Until the proposed roll-up, the investment performed as expected. In the later part of 1990, I received notice that this fund would be merged with another and be called Milestone Properties Inc. I voted against the proposal and as a result received a couple of telephone calls asking me to reconsider. I told the callers I didn't think the merger of the two funds was a good deal for my fund and that my no vote stood. With the merger, my 5 units became 87 shares of Common and 272 shares of Preferred with my invests now worth about $3,600 and the annual return of about $400 was halved. I sold my shares in Milestone in October, 1992 for $1,472, I understand that I will be receiving some additional income as the result of a class action suit, but I will not hold my breath waiting for it.

That is the story of my experiences with partnership rollups and I again would request that you support "The Limited Partnership Rollup Reform Act of 1993" since I have two more partnerships that I feel are candidates for rollup.

Thank you.

SUMMARY OF STATEMENT BY JOE M. BRIDGES

PRESIDENT OF KELLEY OIL CORPORATION

Introduction

The controversy surrounding abuses in rollup transactions has diverted attention from fair and beneficial rollups. It has prompted legislative and regulatory proposals that could discourage constructive transactions along with the abusive ones. These proposals are being made without an adequate impact assessment of recent initiatives by the SEC, the NASD and state securities commissions. This Statement will address both the existing and proposed initiatives from a sponsor's perspective. Our experience as a sponsor of successful oil and gas limited partnerships whose investors have benefited from exchange offers that are an integral part of their original business plan leads to the conclusion that any additional rollup requirements should at least be flexible enough to avoid unintended results such as appraisal rights for transactions already supported by an independent appraisal.

Background

I am the President of Kelley Oil Corporation ("Kelley Oil") (NASDAQ/NMS: KOIL). Kelley Oil serves as the managing general partner of Kelley Oil & Gas Partners, Ltd. ("Kelley Partners") (AMEX: KLY) and publicly held development drilling programs ("DDPs") offered preemptively each year to Unitholders in Kelley Partners to engage in development drilling operations on properties of Kelley Partners.

Kelley Partners was formed through an exchange offer completed in January 1986 combining 21 smaller oil and gas programs managed by Kelley Oil. The transaction involved over 1,100 investors, most of whom had invested with Kelley Oil and its predecessors since the early 1970's. The exchange offer was structured to preserve for these investors the historical business relationships and options that had been the cornerstones of the original programs. Four features were essential to the structure for the new partnership:

• A requirement for quarterly distributions of at least 75 percent of operating cash flow without reduction for development, acquisition and exploration costs or repayment of principal on partnership borrowings;
• An opportunity to invest in the further development of the properties through a preemptive right to participate proportionately in DDPs, but with no obligation to do so;
• An undertaking by Kelley Oil to purchase for its own investment account all units in DDPs that are not purchased preemptively by Unitholders in Kelley Partners, ensuring that necessary development would proceed at the levels proposed for the DDPs; and
• An objective for Kelley Partners to acquire the properties of the DDPs through exchange offers of its publicly traded Units, newly issued for interests in the DDPs at the appropriate stage of their production history.

This structure was designed to allow Kelley Partners to reduce its drilling risk and capital requirements while retaining the ability to increase cash flow and reserves through a 20 percent reversionary interest after payout of each DDP, which it receives in exchange for its assignment of drilling rights to the DDPs. The structure also enables Kelley Partners to expand its reserve base at a relatively low risk level while preserving its capital and providing its active investors who elect to take the risks of DDP investments with liquidity and an increase in their position in Kelley Partners reflecting the fair value of their interest in mature DDPs. Kelley Oil has sponsored one DDP each year since 1987. These DDPs have completed public offerings for a total of approximately $155 million, of which $50 million was invested by Kelley Partners' active investors and the balance of $105 million was invested by Kelley Oil on the same terms as other investors for an average interest of 67.7 percent in program costs and revenues.

During the last three years, Kelley Partners completed separate exchange offers for interests in each of the first three DDPs formed from 1987 through 1989. The exchange value of each DDP was based on the present value of its audited oil and gas reserves computed in accordance with the requirements of the SEC for financial reporting of proved reserves. The market value of the Units received by investors in those DDPs, together with the distributions made by the DDPs prior to the rollups, reflected internal annual rates of return exceeding 35 percent and 50 percent for the first and second DDPs, respectively, and a negative return for the third DDP resulting from lower oil and gas prices and reserve levels for that program at the time of the transaction. Kelley Partners recently filed a registration statement with the SEC covering an exchange offer for interests in the fourth DDP formed in 1990. The transaction has been structured like the prior DDP rollups and will result in an internal annual rate of return of about 30 percent for this program.

The approval rates for the prior DDP rollups averaged over 98 percent. While a few investors did not respond at all, only a single investor cast a negative vote. Of the 17,590,000 outstanding units eligible to vote in these exchanges, that single nonconsenting investor owned only 10,000 units. Although Kelley Oil's investments in the exchanged DDPs were large enough to enable it to control the majority vote for these transactions, the likelihood of management control and an eventual exchange offer was highlighted in the original offering prospectus of each DDP, and the rollups conformed to investors' expectations.

Potential Benefits of Rollups

Since its inception in 1986, Kelley Partners has enjoyed success, reflected by distributions to our investors totalling $9.59 per Unit, with a current cash distribution rate of $1.20 per Unit. During this period, Kelley Partners has almost tripled its proved reserves while replacing production aggregating over 76 billion cubic feet of natural gas equivalents, representing more reserves than we began with. The market price of the Units in Kelley Partners was $12⅛ at inception and has averaged around $15 during the last year, while average prices for domestic natural gas at the wellhead have decreased roughly 25 percent from $2.40 per MMBtu in the year prior to Kelley Partners' inception to $1.83 per MMBtu in the last year. These and other positive points were ignored in favor of misleading statistics in a 1992 Barrons article on "Curbing Roll-Ups." To Barrons' credit, it reprinted in full our response to its rollup article, which we highlighted in our follow-up letter to the members of this Committee and your counterparts in the House.

Also ignored in the Barrons article were the subsequent rollups by Kelley Partners for interests in the affiliated DDPs. These transactions not only give investors the liquidity of publicly traded Units with a relatively stable market value in exchange for their illiquid DDP units but also add to their original position in Kelley Partners, which continues their ongoing cash distributions and provides a potential for market appreciation. The rollups also provide an exit vehicle from their DDP in-

vestments at a point when the DDPs' prospects could not compare with those of Kelley Partners, given the DDPs' lack of additional development potential. Without these rollups, DDP investors would face decreasing returns as the DDPs' fixed number of wells produce out their reserves. Moreover, the rollups do not change the fundamentals of their DDP investment, since the business purposes and policies of Kelley Partners, including its partner allocation and management compensation structure, business plan and cash distribution policy are similar to those of the DDPs, and the voting rights of the Unitholders in Kelley Partners are essentially the same as those of DDP investors.

Existing Regulatory Environment

Adequacy of SEC Rules. Kelley Partners' registration statement covering its 1992 exchange offer for interests in the third DDP was reviewed by various divisions of the SEC for compliance with the rollup disclosure rules added as Article 9 to Regulation S–K in October 1991. Those new rules and the associated review procedures were extremely rigorous, spanning a period of more than four months. They resulted in a disclosure document that left no potential risk or possible disadvantage of the transaction unexplored. First-hand experience in a fair and beneficial rollup suggests that the SEC's revamped disclosure requirements and intense review procedures should be more than adequate to ferret out abusive tactics and curtail unfair transactions.

Adequacy of State Qualification Requirements for Supporting Appraisals in Oil and Gas Exchange Offers. In October 1991, the North American Securities Administrators Association ("NASAA") amended its guidelines for oil and gas programs to address rollup issues. The amendments have been added to the qualification rules under the "blue sky" laws in many states and effectively prohibit any securities offering by oil and gas programs in those states unless their partnership agreements include a comprehensive set of substantive and procedural requirements for any rollup transaction in which the program may participate. In particular, the determination of the exchange value for the transaction must be supported by an independent expert's appraisal of the program's net assets assuming an orderly liquidation on a cash basis over a reasonable period of time. This appraisal requirement was added to the partnership agreements of the 1990, 1991, and 1992 DDPs and has been implemented for Kelley Partners' proposed exchange offer for interests in the 1990 DDP.

Duplicate Appraisal Requirement under California Law. Section 25014.7 added to the California Code in September 1992 defines an "eligible rollup transaction" and places on a sponsor the burden of proof that its proposed rollup meets this definition. To satisfy the new set of rollup requirements, Kelley Partners must offer dissenters' rights in California, including the right to receive compensation in several acceptable forms based on an appraisal. Kelley Partners is unwilling to volunteer a second appraisal, particularly when the appraisal now being performed in accordance with the DDP partnership agreement is expected to reflect a valuation at least 10 percent below the exchange value determined by Kelley Oil. It is currently unclear whether the California Securities Regulation Division will accept this position.

Potential Effects of Pending Legislation and NASD Rules

Compounded Duplication of Appraisal. The appraisal requirements under the pending Federal legislation and the implementing rules proposed by the NASD will compound the duplication problem under the California statute. The clarification by the NASD that the appraisal be conducted in accordance with industry standards will not solve the problem, since any oil and gas appraisal that involves a redetermination of reserve quantities would entail prohibitive costs and yield unreliable results unless conducted by petroleum engineers familiar with the field geology and reservoir characteristics of the acquired reserves. For this reason, the DDP partnership agreements include specifically tailored provisions negotiated with state securities commissions to address these issues, including a provision requiring that the appraisal conducted prior to the rollup rely on the reserve quantities determined in the audited reserve report for the DDP.

Interference in Business Relationships. By adding dissenters' rights that were never bargained for by investors or sponsors, the pending initiatives would unilaterally alter the contractual relationship among the parties, discourage many rollups without regard to the merits and substantially increase the transactional costs for the few rollups that do go forward. This requirement could also serve to diminish the value of limited partnership investments in programs that include future rollups as part of their business plan. Exchange offers by Kelley Partners for interests in DDPs were bargained for and expected by both investor constituencies to further

Kelley Partners' reserve growth and preserve its capital while providing liquidity for its active investors who participate in the DDPs. These beneficial exchange offers should not be deterred or burdened with the unnecessary expense inherent in duplicate appraisals.

Need for Exemption on Appraised Rollups. For oil and gas programs like the DDPs that already include detailed requirements for a supporting appraisal underlying the exchange value determination, the apparent protection of a dissenter's right to a second appraisal is illusory. A second appraisal would be redundant and wasteful. The pending initiatives should at least be refined so that rollups already supported by an independent appraisal are exempted from the requirement of offering dissenters a second appraisal.

Conclusion

The pending initiatives may involve other unintended effects in particular situations or industries. They are being promoted when existing regulatory initiatives have been given inadequate time to test their effectiveness. The proposed legislation and implementing rules are an overreaction and should be reconsidered or at least refined to eliminate the anomaly of duplicated requirements.

WRITTEN TESTIMONY OF SPENCER J. JEFFERIES

PRESIDENT OF PARTNERSHIP PROFILES, INC.

EXECUTIVE SUMMARY

The damage caused by abusive roll-ups to the savings of tens of thousands of small investors is both well documented and indisputable. To be fair, it should be noted that there is nothing inherently wrong with the concept of a roll-up. Indeed, there are a number of benefits that can be derived through partnership consolidations such as liquidity for investors, cost savings through administrative and operational efficiencies, and allowing for various economies of scale through the operation of one large entity versus numerous individual partnerships.

Unfortunately, however, the vast majority of roll-ups done thus far have been structured by general partners in such a way that any potential benefits resulting from the roll-ups have been more than offset by negative factors. As a result, most roll-ups have been grossly unfair to investors while unjustly their enriching general partners.

With the plight of rolled-up investors making its way to the mainstream media in recent years, various regulatory bodies—including the SEC, the NASD and the State of California—have taken action to curb abusive roll-ups. While these efforts are to be commended, they all fall short of providing the much-needed investor safeguards and across-the-board consistency that only Federal legislation can provide.

With respect to the new SEC rules relating to roll-ups, this has amounted to little more than simply re-shuffling the information in the voluminous and intimidating roll-up documents provided to investors. This purely procedural change has provided no substantive protection to investors.

A much more serious èffort to protect investors from abusive roll-ups has been undertaken by the NASD which should be commended for being proactive in responding to the problem of abusive roll-ups. Unfortunately, however, the NASD's proposed rules with respect to roll-ups will only come into play if broker-dealers participate in the roll-up or if the new entity created by the roll-up is to be listed for trading on NASDAQ.

With respect to the prohibition against broker-dealers participating in abusive roll-ups, we already know that some of the most abusive roll-ups that have taken place have not even involved broker-dealers. In fact, the trend in the partnership industry today is *not* to use a broker-dealer when doing a roll-up. As for the NASD's proposal that a roll-up must provide certain investor protections or it may not be listed on NASDAQ, this prohibition would prove equally as hollow in stopping abusive roll-ups since other exchanges have been more than willing to list even the most abusive roll-ups.

By far the most substantive effort to protect investors from abusive roll-ups has been carried out by the State of California. The primary ingredient of the recently enacted roll-up law in this state is that it mandates that dissenters' rights be offered to investors rejecting a rollup proposal.

While the new California law represents an important step in protecting investors from abusive roll-ups, it should not be considered a viable, long-term solution to this problem. Since the law applies only to roll-ups involving California investors, its reach is somewhat limited. Further, it is my understanding that certain groups have

recently begun quietly laying the groundwork to water down the California law through new legislation.

Despite the various regulatory efforts to stop abusive roll-ups, the fact remains that only Federal legislation can provide the comprehensiveness and consistency this matter deserves to ensure the protection of millions of partnership investors throughout the country.

After reviewing the proposed Federal legislation, it is my opinion that, if enacted, it would go a long way toward rendering abusive roll-ups a thing of the past while also providing much needed uniformity and consistency on this issue. As a result, I respectfully encourage the Subcommittee to proceed swiftly to enact this new legislation.

With so many general partners actively maneuvering to hang on forever to the assets they have under management and thus annuitizing their fee streams, the motivation to do a rollup is now as strong as it ever was. In closing, it is my belief that if Federal legislation curbing abusive roll-ups does not come to pass and the spotlight is taken off these transactions, the SEC will be unable to keep up with all the new roll-up filings flooding its offices as fee-hungry attorneys and investment bankers push to roll-up every last partnership. And many general partners who have seen their fellow sponsors make out like bandits in their own self-serving roll-ups will be more than happy to jump on the roll-up bandwagon.

Mr. Chairman and Members of the Subcommittee: My name is Spencer Jefferies. I serve as president of Partnership Profiles, Inc. which I founded in 1988.

Please allow me to begin by expressing my appreciation to you for the opportunity to appear before you today in support of Federal legislation to curb abusive roll-ups. I have been following this legislation since it began over two years ago and would like to commend this Subcommittee for its steadfast efforts to protect partnership investors from unfair roll-ups despite the obstacles placed in its path.

As a very brief introduction, my firm provides research to the securities brokerage industry on between $40 and $50 billion of partnership investments. In connection with this research we have analyzed and written on virtually every major roll-up that has occurred in the past four years. I want to emphasize that my firm is an independent research company in the truest sense, in that we receive no compensation whatsoever from general partners other than regular subscription revenues for our publications. From an economic or financial standpoint, I have no real interest in trying to see that Federal roll-up legislation goes one way or the other. I am strictly an industry observer who is dismayed at what has happened to the savings of small, unsophisticated investors as the result of abusive roll-ups.

The damage caused by abusive roll-ups to the savings of tens of thousands of small investors is both well documented and indisputable. To be fair, I must point out that there is nothing inherently wrong with the concept of a roll-up. Indeed, there are a number of benefits that can be derived through partnership consolidations such as liquidity for investors, cost savings through administrative and operational efficiencies, and allowing for various economies of scale through the operation of one large entity versus numerous individual partnerships.

Unfortunately, however, the vast majority of roll-ups done thus far have been structured by greedy general partners in such a way that any potential benefits resulting from the roll-ups have been more than offset by negative factors. As a result, most roll-ups have been grossly unfair to investors while unjustly their enriching general partners.

The reality of roll-ups is that investors have unwittingly voted in favor of even the most abusive roll-ups because of high-pressure tactics by general partners and because investors never really understood what it was they were voting on in the first place. I know from my own conversations with roll-up victims who have contacted my firm that these investors are far from sophisticated when it comes to understanding the true ramifications of these transactions. As an experienced analyst, even I have difficulty trying to figure out these transactions which requires me to read and re-read hundreds of pages of complex legalese and financial statements. In fact, I recently spent more than two full weeks analyzing a major roll-up proposal that is now seeking regulatory approval.

To expect the average partnership investor—or for that matter the average anybody—to fully comprehend a roll-up proposal is unreasonable, regardless of how the disclosure has been arranged and to how many syllables each word has been limited. If these transactions weren't so complex that the average person could understand them, the history of roll-ups might make for a movie that would move *Barbarians At The Gate* to the Disney Channel.

The tens of thousands of partnership investors caught up in bad roll-ups are justifiably confused and angry over what's somehow legally happened to them. They've

simply lost faith in the system. From my conversations with them it seems likely that many of these small investors may never again consider investing in anything even as safe as a money market mutual fund. Clearly, abusive roll-ups tear at the very fabric of our securities markets.

Attempts at Roll-Up Reform

With the plight of rolled-up investors making its way to the mainstream media in recent years, various regulatory bodies—including the SEC, the NASD and the State of California—have taken action to curb abusive roll-ups. While these efforts are to be commended, they all fall short of providing the much-needed investor safeguards and across-the-board consistency that only Federal legislation can provide.

SEC Rules

With respect to the new SEC rules relating to roll-ups, this has amounted to little more than simply re-shuffling the information in the voluminous and intimidating roll-up documents provided to investors. This purely procedural change has provided no substantive protection to investors and can be likened to rearranging the deck chairs on the Titanic as the saying goes.

The issue of abusive roll-ups is not whether investors have been provided with complete and full disclosure, but whether the typical investor can fully understand what it is that's being disclosed. I equate the average investor's ability to make heads or tails out of what's really happening in a roll-up to my own ability to comprehend NASAA's formula for rocket fuel. In fact, it is my firm belief that any investor with the ability to comprehend all of the in's and out's of a roll-up proposal would probably never have invested in something as complex as a limited partnership in the first place. But at the same time I don't buy the view apparently held by some that these investors deserve exactly what they get.

NASD Rules (Proposed)

A much more serious effort to protect investors from abusive roll-ups has been undertaken by the NASD which should be commended for being proactive in responding to the problem of abusive roll-ups. Unfortunately, however, the NASD's proposed rules with respect to roll-ups will only come into play if broker-dealers participate in the roll-up or if the new entity created by the roll-up is to be listed for trading on NASDAQ.

With respect to the prohibition against broker-dealers participating in abusive roll-ups, we already know that some of the most abusive roll-ups that have taken place have not even involved broker-dealers. In fact, it is my understanding that one of the witnesses on this panel was caught up in what is considered to be one of the most abusive roll-ups ever consummated, and this particular roll-up did not involve a broker-dealer nor was it listed for trading on NASDAQ. Indeed, we have seen that those roll-ups generally considered the most abusive have not involved broker-dealers at all.

The trend in the partnership industry today is *not* to use a broker-dealer when doing a roll-up. Sponsors are opting to go this route for a number of reasons, not the least of which is the fact that it's really not even necessary to use a broker-dealer. By not involving a broker-dealer, roll-up promoters hope to keep these controversial transactions off the radar screen to the extent possible while also keeping transaction costs to a minimum which is important since the sponsor may be required to absorb some of the costs of a busted roll-up. To do a roll-up these days all a sponsor needs to do is hire a non-broker-dealer investment banker and a proxy solicitation firm with a toll-free phone number and they're off to the races.

With respect to the NASD's proposal that a roll-up must provide certain investor protections or it may not be listed on NASDAQ, this prohibition would prove equally as hollow in stopping abusive roll-ups since other exchanges have been more than willing to list even the most abusive roll-ups. Indeed, it is not clear whether these exchanges have applied any standards at all when it comes to listing roll-ups.

Because it seems unlikely that the NASD's proposed rules to protect investors from abusive roll-ups will amount to much of anything even if these rules are enacted, I don't feel that it is necessary for me to even go into the numerous loopholes that exist within these proposed rules.

California Law

By far the most substantive effort to protect investors from abusive roll-ups has been carried out by the State of California. The primary ingredient of the recently enacted roll-up law in this state is that it mandates that dissenters' rights be offered to investors rejecting a roll-up proposal.

This new law has already been put to the test, and it appears to be fulfilling its purpose exactly as designed. I believe that the new California law should serve as a model for Federal legislation, with dissenters' rights serving as the cornerstone. At the very least, any Federal legislation should be as comprehensive as the California law, especially if state law is to be preempted by new Federal legislation.

While the new California law represents an important step in protecting investors from abusive roll-ups, it should not be considered a viable, long-term solution to this problem. Since the law applies only to roll-ups involving California investors, its reach is somewhat limited. Further, it is my understanding that certain groups have recently begun quietly laying the groundwork to water down the California law through new legislation.

Despite the various regulatory efforts to stop abusive roll-ups, the fact remains that only Federal legislation can provide the comprehensiveness and consistency this matter deserves to ensure the protection of millions of partnership investors throughout the country.

The Contract Rights Argument

The primary argument raised by those opposed to subst. ntive roll-up reform is that it would interfere with the existing contract between the general partner and limited partners as laid out in the partnership agreement. While one might consider the relationship between a general partner and its limited partners in this fashion, the reality is that investors believed they were putting their money into an investment product alongside an investment manager—*not* in some sort of one-sided contract that their investment manager might someday exploit for its sole benefit to the detriment of the very investors the manager is charged with representing. By legislating minimum standards to protect investors from abusive roll-ups, about the only right general partners will lose will be their perceived "right" to short-change their own unwitting investors through complex roll-up transactions.

To permit partnership investors to continue to be ripped off by bad roll-ups simply because it is neither expressly prohibited in a contract nor out and out illegal, is in my view unconscionable. The belief held by some that these small investors should have known what they were getting into when they invested in a limited partnership is tantamount to saying that in roll-ups partnership investors deserve exactly what they get. I personally find this apparent reasoning particularly distressing.

As the owner of a small business, I'm a strong advocate of the free market system and of having as little governmental interference as possible. At the same time I realize that without proper regulations in place, events will take place that cause investors to lose confidence in our capital markets. And I can assure this Subcommittee that many of the investors I've spoken to who have been bowled over by bad roll-ups have indeed lost faith in the system they thought would protect them from unscrupulous operators. Clearly, there must be reasonable regulations put into place to ensure the integrity of our capital markets regardless of whether a small limited partnership or a multi-billion dollar mutual fund is involved. Unfortunately, abusive roll-ups have served as proof that investors in limited partnerships have typically been placed at the bottom of the totem pole when it comes to regulatory protections as compared to other investment vehicles such as mutual funds.

A Fiduciary Obligation to Roll-Up?

The latest pro-roll-up argument circulating among general partners these days is that sponsors of real estate partnerships have a fiduciary obligation to seriously consider rolling up their partnerships into real estate investment trusts, commonly referred to as REITs. This new rationale is due to the fact that the shares of many REITs are now trading at premiums compared to their underlying net asset values, and that a roll-up into a REIT could result in more value to investors than if their partnerships were liquidated.

Based on the premiums at which some REITs are now trading, there is certainly some merit to this argument. But even before this somewhat rare phenomena came into being, there was nothing inherently wrong with the concept of rolling up partnerships into REITs or any other type of entity *if* it was truly a good deal for investors. Unfortunately, the fact is that most roll-ups have *not* been a good deal for investors. Contrary to the rhetoric espoused by those opposing roll-up reform, no one is suggesting that all roll-ups be banned, but instead to ensure that these transactions are fair to all parties. We would not be here today if it were not for the fact that with most roll-ups general partners have chosen to check their conscience and their fiduciary obligations to investors at the door.

FEDERAL ROLL-UP LEGISLATION IS NEEDED

After reviewing the proposed Federal legislation, it is my opinion that, if enacted, it would go a long way toward rendering abusive roll-ups a thing of the past while also providing much needed uniformity and consistency on this issue. There will be those who argue that Federal legislation is now unnecessary, that market forces have now come into play to keep bad roll-ups from being consummated. But the truth is that market forces have hardly ever been brought to bear on roll-up transactions, and the millions of investors who could be impacted by roll-ups are no more able to comprehend these complex transactions than they were three months or even three years ago.

Others will seek to water down any Federal legislation to fit their own agenda. On this I strongly urge the Subcommittee against underestimating the ability of a greedy general partner and a roomful of smart New York lawyers to exploit even the smallest loophole in any new law for their own enrichment and to the detriment of their own investors. And since general partners will use partnership funds to pay for the roll-up costs—including the roomful of $400-an-hour New York lawyers—it will not be cost prohibitive for general partners to find and exploit any cracks in the new legislation.

Opponents of roll-up reform will also point to a small handful of "fair" roll-ups that have occurred as evidence that Federal legislation is unnecessary. While such roll-ups may have occurred, this is of little consolation to the tens of thousands of small investors who have already been the victims of abusive roll-ups, as well as the millions of other investors who will be lined up for the kill if Federal legislation does not come to pass. To maintain the status quo based on the premise that a few somewhat obscure roll-ups have been fair to investors would be to roll out the red carpet for abusive roll-ups.

Still, some argue that roll-up reform is just more unnecessary special interest legislation. Well, if the interests of more than eight million small investors can be so easily written off as unimportant up here, then so be it. But the truth is that the real special interest group in this legislation consists of a small handful of well-heeled general partners, lawyers and investment bankers which are working to kill or at least make Swiss Cheese out of this legislation. And the irony is that much of their funding for these efforts is coming from the very investors this legislation is designed to protect, and these people don't even know it.

With so many general partners actively maneuvering to hang on forever to the assets they have under management and thus annuitizing their fee streams, the motivation to do a roll-up is now as strong as it ever was. In closing, it is my belief that if Federal legislation curbing abusive roll-ups does not come to pass and the spotlight is taken off these transactions, the SEC will be unable to keep up with all the new roll-up filings flooding its offices as fee-hungry attorneys and investment bankers push to roll-up every last partnership. And many general partners who have seen their fellow sponsors make out like bandits in their own self-serving roll-ups will be more than happy to jump on the roll-up bandwagon. Thank you.

SUPPLEMENTAL WRITTEN TESTIMONY OF THE NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS, INC.

The National Association of Real Estate Investment Trusts, Inc. (NAREIT) respectfully submits the following comments to the Subcommittee on Securities of the Senate Banking, Housing, and Urban Affairs Committee during its consideration of S. 424, "The Limited Partnership Rollup Reform Act of 1993." These comments are submitted in addition to the oral testimony presented on behalf of the Association before the subcommittee on April 20, 1993.

NAREIT is the national trade association for the REIT industry. It represents over 150 qualified REITs and more than 650 law firms, accounting firms, brokerage firms and others involved in the REIT industry. NAREIT was founded in 1960,[1] when the REIT industry's enabling legislation was enacted in the tax code.

I. BACKGROUND

Real estate investment trusts, or REITs, are often described as mutual funds for real estate. Like mutual funds, REITs are generally organized as ordinary corporations (some may be formed as business trusts) and are entitled to a deduction for dividends paid to shareholders. In order to be entitled to the dividends paid deduction, the tax laws generally require that REITs operate as passive investors in rent-

[1] NAREIT was originally known as the National Association of Real Estate Investment Funds (NAREIF). Its name was changed when it reorganized in 1972.

al properties or mortgages, and mandate that REITs pay out at least 95 percent of their net income to shareholders each year.

REITs differ from partnerships in many respects. They generally do not pass through the character of their income to investors,[2] nor do they pass through credits, losses or deductions. REIT shareholders benefit from receiving the simplified Form 1099 for dividends, rather than the more complex Schedule K–1 for partnerships. Generally, a majority of a REIT's board of directors must be independent of management under state law. As is the case with corporate shareholders generally, REIT shareholders are entitled by law to elect or remove board members as they see fit. As corporate investors, REIT shareholders are also entitled to the procedural protections afforded by state corporation laws for mergers and other major restructurings, including the provisions for dissenters appraisal rights. Unlike most partnership interests, REIT shares must (under the REIT tax provisions) be freely transferable and most REIT shares are listed for trading on either the national stock exchanges or in the secondary stock markets.

II. DISCUSSION

A. Opposition to S. 424

NAREIT has consistently maintained over the past two years that the REIT industry was not part of the rollup problem, and that it can and should be part of the solution to the problem. REITs offer partnership investors an opportunity to convert their interests into freely tradable corporate securities in an industry that is subject to the discipline and scrutiny of the public markets. As noted in the Association's oral testimony before the subcommittee,[3] total returns on equity REIT shares over the past twenty years, and especially over the past two years, have been exceedingly strong. We firmly believe that the REIT vehicle offers a very positive alternative to limited partners whose investments are languishing in illiquid and perhaps poorly managed partnership vehicles. NAREIT has always been concerned that the proposed rollup legislation risks taking away this important investment, alternative for perhaps hundreds of thousands of limited partners.

Nevertheless, when the first rollup legislative proposals were introduced, NAREIT neither supported nor opposed the proposals, but limited its comments to the overly broad scope of the legislation and to certain other technical matters. At the time, abuses were in fact occurring in connection with some partnership rollups, notwithstanding that those transactions were approved by a majority of the limited partners involved.[4] Since those bills were introduced, however, many important developments have occurred that have convinced the Association to oppose this legislation.

Over the past two years, more than 40 new REITs have begun trading, including almost two dozen initial public offerings, most of which would have been considered rollups under the first rollup bills introduced in Congress. It is fair to say that many of these transactions might never have been done, or even considered, if one of the original rollup bills had been enacted.[5] Yet, today, virtually every one of these new REITs is trading well above its initial trading price and paying regular dividends to shareholders.[6] In fact, in sharp contrast to several years ago, some analysts maintain today that real estate managers have a fiduciary obligation to recommend rollup conversions into a REIT to their investors.

On October 30, 1991, the Securities and Exchange Commission adopted extensive regulations (referred to herein as the "900 rules")[7] affecting the disclosure obligations and other matters in connection with the proxy and registration statements involving rollup transactions. In addition, the National Association of Securities Dealers has submitted proposed rule changes affecting rollups to the SEC and the

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[2] Capital gains may be passed through to shareholders.

[3] *See*, TESTIMONY OF THE NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS, INC. BEFORE THE SUBCOMMITTEE ON SECURITIES OF THE SENATE BANKING COMMITTEE by Louis J. Garday, Sr. Vice President, NAREIT, April 20, 1993.

[4] Many of the partnership rollups experienced precipitous declines in the trading values of their newly listed securities soon after trading began. It was not possible then, nor is it now, to quantify the extent to which the trading losses were attributable to abusive practices associated with the rollups, or to a simple over-valuation of the underlying real estate assets during the onset of a nationwide real estate depression.

[5] The Association is mindful that the current legislative proposal includes several reasonable exemptions, not included in the original rollup bills, for certain transactions that are unrelated to the rollup problem. Nevertheless, it submits that the legislation remains over-broad in its current form and, if enacted, will foreclose many beneficial transactions.

[6] *See REITWatch*, The National Association of Real Estate Investment Trusts, Inc. (March 1993).

[7] 17 C.F.R. Parts 210, 229, 239 and 240. The substantive provisions of the regulations are found in Items 900, *et seq*, of Part 229.

North American Securities Administrators Association has adopted rollup guidelines for a variety of offerings subject to blue sky registration procedures. California and Massachusetts have enacted, respectively, legislative and regulatory measures addressing rollup transactions. Without specifically endorsing any of the existing governmental and agency responses to rollups, NAREIT observes that the regulatory environment for these transactions has changed dramatically over the past two years.

Investors have also become more sophisticated about rollup transactions than they were in the late eighties. To the best of our knowledge, underwriters will not even consider transactions involving the types of abuses associated with early rollup transactions. The market today does not tolerate practices such as paying brokers only to solicit rollup approvals from limited partners, extensive conflicts of interest, overly generous compensation for general partner interests, etc. Many of the highly successful initial offerings of REIT shares during the past two years involved the conversion of existing limited partnerships, yet these transactions did not involve the types of abuses associated with the early partnership rollups.

Accordingly, NAREIT does not believe the proposed rollup legislation is needed at this time. Whether attributable to changes in the economy, existing regulatory responses to rollups or increased investor sophistication, the rollup problems of the past appear to be resolved. Corrective Federal legislation is not needed.

NAREIT further opposes the legislation because of the risk that it will do more harm than good to the people it is intended to protect. Many faltering limited partnerships that could be revitalized by an initial public offering in the corporate securities markets will be unable or unwilling to fulfill all the requirements of S. 424 (or, the more onerous requirements of its House counterpart, H.R. 617), because of the substantial expense and delays attendant thereto.

In other instances, because of the breadth and ambiguity of the proposed legislation, compliance with its requirements may force a company to adopt a plan of reorganization that is more harmful to investors than the company's own preferred plan. In a recent case in California, involving one of the first companies to seek compliance with California's rollup statute, the California Department of Corporations prohibited the applicant from including its real estate management operations in its proposed new REIT offering. The governmental decision was made, notwithstanding a clear market preference to consolidate management in a REIT in order to gain operating efficiencies and avoid conflicts of interest. As reported in an article discussing the transaction in the April 12, 1993 issue of Barron's, "[s]aid one industry veteran, '[the adverse result] probably wasn't intentional. Nevertheless, it definitely hurts the very investors the legislation was designed to protect.'"

Accordingly, NAREIT urges the Subcommittee to reconsider whether this legislation is necessary or appropriate to fulfill its purpose. Until there is an obvious and pressing need for Federal legislation, the Subcommittee should defer any further action on this bill.

B. Analysis of S. 424

Although the Association is opposed to S. 424, there are several important amendments that should be made to the bill if it is enacted into law. Generally, the Association prefers the Senate version, S. 424, of the rollup bill over that recently passed in the House of Representatives, H.R. 617. However, NAREIT is also concerned that without the following proposed changes to S. 424, this legislation risks stalling the economic recovery that is now underway in the securitized real estate market.

1. Rollup Definition

The most serious flaw in the bill is the scope of the transactions to which it applies. The controversial rollups in the late eighties almost always involved the merger of non-listed real estate (or, to a much lesser extent, oil and gas) limited partnerships whose general partners were identical or affiliated, which encouraged inflated fees and excessive compensation to the general partners. The disclosure documents were sometimes intentionally confusing and complex, with inadequate summaries of the transaction. In some cases, the voting rights of limited partners were allegedly abridged when their interests were converted into shares of a new entity. Brokers were paid only for soliciting approvals from limited partners, and the exchange values of the securities were often inflated. However, the potential application of the proposed rollup legislation extends far beyond these abusive practices.

With certain narrow exceptions, the rollup bill defines any ". . . combination or reorganization of limited partnerships, directly or indirectly, in which some or all of the investors in the limited partnerships receive new securities or securities in

another entity . . ." as a rollup.[8] Under this definition, arguably the sale of assets to a buyer in exchange for triple A-rated corporate bonds is a rollup. Similarly, the exchange of an office building for the stock of a widely-traded, blue-chip company such as Microsoft, would be considered a rollup. Indeed, even a simple bankruptcy reorganization would likely be considered a rollup.

The application of the SEC's 900 rules is probably a good indication of the types of transactions that will be impacted by this bill. Although we do not have specific statistics, NAREIT understands that a majority of the SEC-filed transactions that are subject to the SEC 900 rules do not involve either real estate or oil and gas partnerships and bear no resemblance to the abusive rollups of the past. Instead, the registrants included family partnerships that failed to meet a Regulation D exemption, research and development companies, high-tech businesses, etc.

If this bill is enacted, it should apply only to abusive rollup transactions, which should be defined based on those characteristics that were common to abusive transactions in the past. Furthermore, no business reorganization or sale of assets should be deemed an abusive transaction solely because of the technical manner in which it is structured. Accordingly, we maintain that no transaction should be subject to the requirements of the bill, unless the transaction includes adverse changes to the rights of limited partners, as described in regulations to be issued by the SEC, which are likely to engender a significant loss of value to investors.

NAREIT proposes the following definition of a rollup in place of the introductory language in proposed new subsection (h)(4)(A) (section 2 of the bill, lines 22–24, p. 7, and lines 1 and 2, p. 8):

> [A rollup is a transaction involving—]
>
> "(A) the merger of two or more real estate limited partnerships (none of the securities of which are reported under a transaction reporting plan declared effective before January 1, 1991, by the Commission under section 11A) that have identical or affiliated general partners and in which the limited partners receive new securities or securities in another entity, provided that the transaction involves adverse changes in the rights of limited partners (as described in regulations issued by the Commission) that are likely to engender a significant loss of value in their investment, other than—"

In connection with the foregoing definition of a rollup, NAREIT recommends retaining all of the exceptions provided in the current bill that follow the general definition.

If the foregoing proposal is not accepted by the Subcommittee, then NAREIT recommends that an exception from the general definition be provided for arms-length transactions between unaffiliated companies. This exception should be in addition to those provided in the existing bill. New clause (vi) should be added to proposed subsection (h)(4)(A):

> [Such term does not include a transaction—]
>
> "(vi) involving securities that are issued in an arms-length transaction for the assets or interests in a partnership, the general partner(s) of which is (are) not affiliated with the issuer."

This exception could be narrowed, yet still retain its essential purpose, if it were made contingent on the newly issued securities having been traded on a national stock exchange for at least twelve months prior to the transaction.

NAREIT also recommends excluding non-acquisitive, or divisive, transactions and bankruptcy or insolvency reorganizations from the proposed new subsection (h)(4)(B) (lines 9–25, p. 9, and lines 1–12, p. 10 of the bill), relating to the reorganization of a single partnership. Insofar as NAREIT is aware, rollup criticisms have never included divisive reorganizations, although such transactions appear to fall within the over-broad definition of a rollup under the bill. Divisive transactions generally occur when a development and leasing company decides to spin-off its rental properties into a separate company, shares of which are distributed pro rata to its investors. It may also be used by a company in order to separate its retail operations from the management duties associated with its real estate. The purpose of the transaction is to achieve operating efficiencies and/or to attract new capital. Similarly, ordinary bankruptcy and insolvency reorganizations do not necessarily involve any rollup issues and should be excepted from the legislation.

2. Effective Dates

Section 2 of the bill, relating to the proxy solicitation rules, is generally effective upon the bill's enactment, thereby making it illegal to solicit rollup proxies of any kind. The SEC is required to issue final regulations implementing this section with-

[8] Proposed subsection (h)(4), line 22–24, p. 7 of the bill.

in twelve months. This section effectively imposes a moratorium on any business reorganizations that are subject to the bill until the SEC issues final regulations, which practically speaking will be twelve months after enactment.

It is imperative that no moratoriums be imposed on such a wide range of business reorganizations. The SEC already has extensive regulations in place regarding rollups (albeit not issued to implement the requirements of this legislation). There is no apparent need to halt the many transactions now underway and thus, jeopardize the economic recovery that is taking place in the securitized real estate markets. The bill should explicitly state that section 2 thereof will not be effective until final regulations are issued.

Section 3 of the bill provides that the national securities exchanges shall issue rules requiring that appraisal and compensation rights, or other comparable rights, be provided to investors in a rollup transaction. This section is made effective eighteen months after enactment. The House version of the rollup bill, H.R. 617, also provides eighteen months for the exchanges to issue appraisal rules, but further provides that section 3 shall apply to any securities issued after the date of enactment of the bill.

In order to avoid an eighteen month moratorium on business reorganizations under section 3, it is imperative that the Senate version of the effective date for this section of the bill be adopted in any final legislation, rather than the House provision.

3. Preemption of State Law

The "Limited Partnership Rollup Reform Act of 1993" represents the first time the Federal Government through its securities laws will attempt to regulate the fairness of securities transactions on a national scale. Historically, this duty has always been left in the province of the states. If this legislation is enacted, its implementation will be a monumental task and there will likely be numerous incidents of conflict and overlapping jurisdictions with state blue sky rules and state corporate and partnership law.

California has already enacted rollup legislation that overlaps and may prove inconsistent with many provisions of the proposed Federal rollup legislation. The California statute applies to any rollup security offered in that state, whether or not the security is traded on a national exchange. Like the Federal legislation, the California law also mandates that the national stock exchanges adopt certain rules and practices that conform with the California rollup statute.

In addition, virtually all states already have appraisal or other comparable rights for minority corporate shareholders in the event of a merger or other major reorganization. California has already extended such rights to limited partners, and other states reportedly are considering doing this. Any of these state laws theoretically could conflict with the proposed Federal rollup law, with respect to the types of transactions subject to appraisal rights, the rules for determining the value of appraisal rights, the types of compensation or other forms of investor protection that are permitted, etc.[9]

The Association recommends that if Federal rollup legislation is enacted, it should preempt state rollup laws, at least to the extent that the securities issued in the transaction are traded on a national exchange. Until the California rollup legislation was enacted, states generally have not required blue sky registration of exchange listed securities. By providing that the Federal law preempts state rollup laws, the statute will preserve the blue sky exemption that historically has been available for listed securities and, more importantly, will avoid extensive potential conflicts in the law.

With respect to ordinary appraisal and comparable rights already available in many states, the Association will be pleased to work with the subcommittee to evaluate potential conflicts in this area and devise legislative solutions. Generally, except in California, such rights are available only in the case of corporate vehicles and would not conflict with provisions of the Senate rollup bill. However, such conflicts may arise in the case of partnerships that are subject to California law, and these conflicts will increase dramatically if more states extend appraisal rights to limited partners. If the House version, H.R. 617, of the rollup bill is enacted, con-

[9] Although most corporate entities, such as REITs, would not be directly subject to the appraisal rules in S. 424, such entities could become subject to these rules if they are "indirectly" part of a limited partnership rollup. In addition, corporate REITs could be directly subject to the appraisal rules, if the House version of the rollup bill (H.R. 617), which applies to limited partnerships and "substantially economically equivalent entities," is enacted.

flicts with state corporate appraisal laws could easily arise, since that bill arguably includes some REITs within its rollup definition.[10]

4. Appraisal and Compensation Rights

Finally, NAREIT recommends that the appraisal and compensation rights, as provided in section 3 of S. 424, be deleted from the bill. Assuming that the SEC's 900 rules are at least partly responsible for the disappearance of abusive rollup transactions, it is clear that the implementation of Federal appraisal rights is not needed. This part of the bill also has the greatest potential for injuring investors, since it will preclude the very partnerships most in need of additional capital from accessing the public markets through a newly organized REIT. As noted in part 3, above, implementation of such rights may also generate significant conflicts with state law.

Implementation of Federal appraisal rights will necessarily involve the stock exchanges (and, ultimately, the SEC and Federal courts) in overseeing the valuation of as yet unlisted companies. The exchanges may also be forced to oversee the provision of monetary or other compensation to dissenting minority investors. Neither the stock exchanges nor the SEC are appropriate entities for enforcing these types of rights, which historically were a matter of state law. Ironically, the enforcement of the proposed appraisal rights will be on behalf of dissenting minority investors, who generally will have elected *not* to receive the exchange-listed securities that will be issued to the approving majority investors. These interests are not within the normal jurisdiction of either the stock exchanges nor the SEC.

Deleting appraisal rights from the bill will not alter those provisions of the bill that address the actual abuses associated with rollups in the past. In addition to the extensive new disclosure rules provided in section 2 of the bill, section 3 will continue to provide that (1) limited partners' voting rights may not be abridged, (2) limited partners may not be required to bear an unfair portion of the costs associated with a rollup, and (3) restrictions must be adopted relating to the exchange of contingent fees or the provision of future services for non-contingent interests.

III. CONCLUSION

NAREIT did not adopt a position on the merits of this bill until it had the opportunity to observe the positive performance of the securitized real estate markets over the past two years, in particular the successful conversion of many illiquid limited partnerships into REITs. The Association finally decided to oppose the bill only after it was convinced that the abusive rollup problems of the past had subsided and that the bill could cause substantial harm to many of the beneficial transactions occurring today.

The existing REIT industry has little to gain and a great deal to lose if a new flurry of abusive partnership rollups occurs using the REIT vehicle. However, NAREIT opposes this bill because it believes it will foreclose future opportunities both for investors and existing REITs, by freezing much of the real estate industry in status quo.

We appreciate the opportunity to present our views to the subcommittee and hope that they are helpful to you in your deliberations. Please let us know if we can provide any further assistance to the subcommittee.

[10] *See* footnote 9.

REITWATCH

A monthly statistical report on the real estate investment trust industry — February, 1993

TRENDS

The NAREIT Share Price Index rose 4.31 points in January to 78.68

- ♦ The Equity REIT Index rose 11.27 points to 209.30
- ♦ The Mortgage REIT Index rose 1.18 points to 19.74
- ♦ The Hybrid REIT Index rose 2.12 points to 57.36

Annualized dividend yields averaged 7.53 percent on January 29, compared to 8.65 percent one year ago

- ♦ Equity REIT dividend yields averaged 6.67 percent, compared to 7.42 percent last year.
- ♦ Mortgage REIT dividend yields averaged 11.00 percent, compared to 13.21 percent last year
- ♦ Hybrid REIT dividend yields averaged 7.55 percent, compared to 7.91 percent last year

Total returns on REIT shares, reinvested monthly, averaged 13.69 percent for the 12 months ending January 29

- ♦ Equity REIT total returns averaged 16.28 percent
- ♦ Mortgage REIT total returns averaged 2.13 percent
- ♦ Hybrid REIT total returns averaged 19.83 percent

Total Returns on REIT shares averaged 6.37 percent for the month ending January 29

- ♦ Equity REIT total returns averaged 6.42 percent
- ♦ Mortgage REIT total returns averaged 7.22 percent
- ♦ Hybrid REIT total returns averaged 4.89 percent

Industry assets total $48.5 billion for 206 tax-qualified REITs

- ♦ Shareholders' equity totals $17.5 billion
- ♦ Equity investments total $20.0 billion
- ♦ Mortgage investments total $24.2 billion

OFFERINGS

Initial Equity Offerings

Business Mortgage Investors, Inc. completed a $49 million private offering of common stock in January. The company is advised by Allied Capital Advisers, Inc. and Mitchell Hutchins Institutional Investors.

Crocker Realty Investors, Inc. announced in January the completion of its offering of one million shares of common stock and two million shares of common stock purchase warrants for $10.2 million. The offering was underwritten by GKN Securities Corporation.

Secondary Equity Offerings

Bradley Real Estate Trust announced in January that it issued 900,000 additional shares of beneficial interest pursuant to the exercise by underwriters of their overallotment option granted in connection with the trust's recent public offering.

CleveTrust Realty Investors announced in December the expiration of their previously announced rights offering. The trust sold 1.759 million shares and raised $4.398 million.

Dial REIT, Inc. announced in January the completion of an offering of three million shares of common stock for $28.5 million. National Westminster Bank, PLC, Capital Markets Branch underwrote the offering.

Health & Rehabilitation Properties Trust announced in January the completion of its offering of 9.0 million shares of beneficial interest totaling $114.75 million. In addition, the company granted its underwriters an option to purchase an additional 1.35 million shares to cover over-allotments. Merrill Lynch & Co., Donaldson, Lufkin & Jenrette Securities Corporation, and Smith Barney, Harris Upham & Co. underwrote the offering.

Meditrust completed an offering in January for 2.85 million shares of common stock for $87.28 million, and an additional $87.25 million in 7 percent convertible debentures due in 1998.

Merry Land & Investment Company, Inc. filed a registration statement in January with the Securities and Exchange Commission for 5.175 million shares of common stock for $76.0 million. The offering will be underwritten by Alex. Brown & Sons; Kidder, Peabody & Co.; and Interstate/Johnson Lane Corp.

(continued on page 2)

REIT ACTIVITIES

(continued from page 1)

Property Trust of America filed a registration statement with the Securities and Exchange Commission in January for 6.325 million shares of beneficial interest for $94.08 million. A portion of the shares will be underwritten by Goldman, Sachs & Co.; A.G. Edwards & Sons, Inc.; Kidder Peabody & Co., Inc.; and Merrill Lynch & Co. The balance will be offered to Security Capital Realty Investors, Inc., the REIT's principal shareholder.

Bond Offering

Asset Investors Corporation announced in January that it issued $8 million of fixed-rate collateralized notes to a group of institutional investors. The notes, which bear 7.7 percent interest, are secured by various CMO ownership interests.

INVESTMENTS

Burnham Pacific Properties, Inc. announced in January that it completed the acquisition of an industrial manufacturing and engineering facility located in Poway, California, for $22.4 million. The acquisition includes 17 acres of land in North San Diego County.

Eastover Corporation announced in January that it acquired title to the Ramada Inn hotel in Kenner, Louisiana in lieu of foreclosure. Eastover plans to market the property for sale in the near future.

IRT Property Company announced in December the completion of an acquisition of the North River Village Shopping Center in Ellenton, Florida. A new retail store adjacent to the present center will be acquired upon completion. The total purchase price for the two phases will be $10.1 million.

LTC Properties, Inc. announced in January that it closed $8.8 million of additional transactions at the end of December. Included in these transactions was the purchase of a long-term care facility for $3.8 million and mortgage loans secured by two long-term care facilities totaling $5 million. The mortgage loans consist of a $3 million loan secured by a 100-bed skilled nursing home in Ohio, and a $2 million loan secured by a 385-bed skilled nursing home in Texas.

LTC Properties, Inc. also announced in January the purchase of a $4.1 million mortgage on a 140-bed skilled nursing home in Illinois.

MGI Properties announced in January that it received a fee for agreeing to the assignment and amendment of a 50,000 square-foot lease at Yorkshire Plaza in Aurora, Illinois. Income from the transaction was $1.03 million.

New Plan Realty Trust announced in January that it contracted to acquire Factory Merchants Mall of Osage Beach, in Missouri, for an all cash price exceeding $30 million.

Pennsylvania REIT announced in January the acquisition of ownership interests in two Florida garden apartment properties containing 696 units. The total project, including proposed renovations, amounted to $18.25 million.

Property Trust of America announced in January that it committed to eight new multifamily projects totaling 2,045 units, representing a total investment of $74.4 million. The properties are located in Arizona, New Mexico and Texas.

Sizeler Property Investors, Inc. announced in January the completion of a purchase of the Steeplechase Apartments, in Lafayette, Louisiana, for $3.5 million.

Sizeler Property Investors, Inc. also announced in January that it acquired three apartment complexes in late December. The properties are located in Alabama and Louisiana, and were purchased for approximately $11 million.

Southwestern Property Trust, Inc. announced in January that it made additional apartment investments totaling $19.1 million in conjunction with the arrangement of a new $12.5 million revolving credit line. The new investments include the $10.2 million purchase of the first mortgage loan on the Windridge Apartments in Dallas, Texas; the $6.1 million purchase of the Bridgeport Apartments in Irving, Texas; and a $2.8 million investment to increase its ownership interest in four apartment properties in Dallas and San Antonio, Texas.

United Dominion Realty Trust announced in January that it purchasee two apartment communities in Tampa and Orlando, Florida, from John Hancock Mutual Life Insurance Company for $7.395 million.

Wellsford Residential Property Trust announced in January the acquisition of two multfamily properties for $18.3 million.

SALES

Duke Realty Investments, Inc. announced in January that it sold a two-story office building. The proceeds from the sale were not disclosed.

Trammell Crow Real Estate Investors announced in January the sale of Royal Lane Business Park in Dallas, Texas, to an individual investor group for $7.5 million.

WILLIAMS ACT FILINGS

The publication of these filings is for informational purposes only and without regard to the intentions of the filing entity.

REIT	ACQUIRER	DATE FILED CHANGE	SHARES %
CleveTrust Realty Investors	Howard Amster	01/05/93 +	299,200 8.07%
CleveTrust Realty Investors	Robert H. Kanner Deferred Compensation Trust B	01/06/93 +	605,000 16.3%
CleveTrust Realty Investors	John D. Weil	01/06/93 +	483,800 13.05%
Storage Equities, Inc.	B. Wayne Hughes	01/07/93 +	1,052,140 6.08%
Property Capital Trust	President and Fellows of Harvard College	01/13/93 -	1,098,400 12.2%
Vinland Property Trust	Lucy N. Friedman	01/14/93 +	881,620 14.7%
Property Trust of America	William D. Sanders	01/21/93 +	6,955,776 25.73%

INDUSTRY PROFILE
Assets by Profile Mix

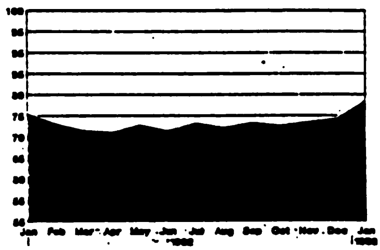
	Number in Group		Assets ($Mil)		Percent of Total Assets	
	Sep-91	Sep-92	Sep-91	Sep-92	Sep-91	Sep-92
Equity REITs	132	144	19,028.7	21,745.3	41.7	44.9
Mortgage REITs	37	35	22,136.1	22,483.0	48.6	46.4
Hybrid	30	27	4,404.4	4,251.5	9.7	8.7
	199	206	45,569.2	48,479.8	100.0	100.0

INDUSTRY STATS

SHARE PRICE INDEX

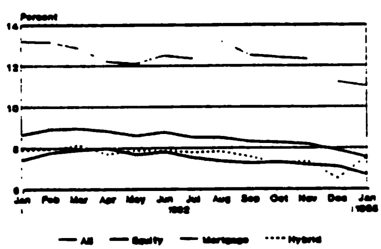
(January 1972 = 100)

	ALL	EQUITY	MORTGAGE	HYBRID
1992				
January	75.43	194.07	22.03	52.58
February	73.17	188.07	21.69	49.97
March	71.63	183.86	21.20	48.86
April	71.12	181.93	21.24	49.30
May	72.86	183.86	21.16	49.30
June	71.46	188.07	20.57	49.17
July	73.37	191.69	20.41	50.77
August	72.25	191.32	19.10	50.79
September	73.46	194.16	19.36	53.36
October	72.70	192.66	18.87	52.40
November	73.61	196.49	18.87	53.02
December	74.37	198.03	18.56	55.24
1992				
January	78.68	209.30	18.74	57.36



ANNUALIZED DIVIDEND YIELDS

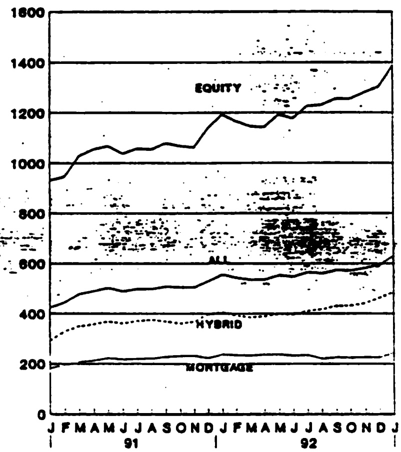
	ALL	EQUITY	MORTGAGE	HYBRID
1992				
January	8.86	7.42	13.21	7.91
February	8.92	7.78	13.16	7.94
March	8.96	7.91	12.86	8.14
April	8.83	7.98	12.21	7.69
May	8.56	7.67	12.11	7.88
June	8.78	7.80	12.51	7.87
July	8.51	7.53	12.34	7.79
August	8.50	7.36	13.23	7.82
September	8.31	7.25	12.53	7.57
October	8.26	7.30	12.48	7.28
November	8.19	7.20	12.33	7.38
December	7.98	7.10	11.21	6.51
1993				
January	7.53	6.67	11.00	7.56



Share price index and dividend yields are calculated as market value weighted averages of all actively traded companies that were tax-qualified REITs for their most recent fiscal year. Dividend yields are based on the annualized most recently paid regular dividend, plus any extra distributions paid during the preceding 12-month period. Total returns represent price appreciation, plus … period.

TOTAL RETURN INDEX
(December 1971 = 100)

	ALL	EQUITY	MORTGAGE	HYBRID
1991				
January	424.12	930.88	182.13	293.18
February	444.98	947.73	195.86	329.76
March	478.90	1029.89	208.26	349.85
April	490.28	1055.97	212.75	357.46
May	501.85	1067.71	222.56	369.07
June	488.84	1037.91	217.46	360.39
July	498.27	1058.85	220.03	370.64
August	498.57	1054.57	221.06	374.97
September	508.20	1080.39	227.52	369.00
October	505.06	1068.51	231.22	360.49
November	505.18	1062.58	231.16	369.05
December	529.08	1138.61	222.72	398.00
1992				
January	555.27	1194.06	238.31	406.16
February	542.38	1165.50	234.93	392.12
March	534.31	1146.15	233.50	384.06
April	535.51	1142.08	236.90	369.40
May	552.75	1191.99	236.93	398.28
June	546.05	1176.38	233.58	397.23
July	564.53	1227.49	234.35	411.12
August	559.65	1231.27	220.20	417.59
September	573.00	1256.65	226.71	431.27
October	571.12	1255.04	223.59	432.29
November	582.24	1281.61	225.79	442.91
December	593.49	1304.73	226.99	464.01
1993				
January	631.29	1388.46	243.38	486.72



Total returns represent price appreciation, plus actual dividends paid, during the indicated period for companies which have been included in the index for the entire period. The Total Return Index represents the cumulative reinvested monthly total return of the NAREIT index. The Twelve Month Total Return represents the unreinvested total return for companies included in the NAREIT index for the entire twelve month period.

INDUSTRY BALANCE SHEET
($ Millions)

	September 1991	September 1992
Assets		
Mortgages:		
Construction & Development	599.8	214.8
First on Completed Properties	6,031.1	6,827.0
Second & Wrap-around	479.1	352.0
Mortgage Pools	16,856.2	16,803.9
	23,966.2	24,197.7
Equity Investments:		
Property Owned	18,215.0	20,456.7
Accumulated Depreciation	(2,191.9)	(2,585.7)
Other	1,980.9	2,147.5
	18,004.0	20,018.5
Total Real Estate Investments	41,970.2	44,216.2
Cash & Other Assets	3,987.2	4,697.6
Loss Reserves	(388.2)	(434.0)
Total Assets	45,569.2	48,479.8
Liabilities		
Mortgages	4,577.8	5,139.3
Mortgage-Backed Bonds	14,992.1	14,088.1
Convertible Debt	992.1	1,217.6
Nonconvertible	1,795.6	2,171.7
Commercial Paper	759.9	873.4
Bank Debt	4,630.9	5,943.4
Other Liabilities	1,502.2	1,659.8
Total Liabilities	29,250.6	31,093.3
Shareholders' Equity	16,318.6	17,386.5
	45,569.2	48,479.8

Calculated from the most recent financial reports of 199 tax-qualified REITs in September, 1991 and 206 in September, 1992. Does not reflect some funds raised during the third quarter of 1992 which may not have been incorporated into published

REIT STATS

REIT NAME	EXCHNG LISTING	SHARE PRICE (01/29/93)	ANNL DIV YIELD	JANUARY MONTHLY RETURN	MARKET CAPITAL ($ MIL)
ALLIED CAPITAL COM	1 ALCC	$17.875	6.48%	0.00%	$196.6
AMER HEALTH PROP	N AHE	$23.625	12.02%	20.38%	$407.2
AMER HOTELS & RLTY	N AHR	$2.000	0.00%	-11.11%	$13.0
ANGELES MTG INV TR	A ANM	$16.375	12.24%	5.87%	$45.6
ANGELES PART MTG	A APT	$16.625	12.05%	0.25%	$43.6
ARIZONA LAND INC	A AZL	$3.563	1.68%	-2.58%	$9.6
ASR INVSTMENT CORP	A ASR	$2.938	27.23%	11.92%	$46.2
ASSET INVESTORS	N AIC	$7.000	5.71%	3.70%	$97.9
BANYAN HOTEL INV	A VHT	$0.094	0.00%	-24.80%	$1.0
BANYAN LAND FND II	1 VBLF	$0.938	0.00%	-6.20%	$18.1
BANYAN MTG INV FD	N VMG	$0.688	0.00%	0.00%	$27.3
BANYAN SH TERM INC	A VST	$1.563	0.00%	8.69%	$10.6
BANYAN STRT LND TR	1 VLANS	$4.000	10.00%	3.23%	$47.9
BERKSHIRE REALTY	N BRI	$9.375	8.53%	8.70%	$238.0
BODDIE-N REST PROP	A BNP	$13.875	8.96%	3 74%	$39.5
BRADLEY REAL EST	A STR	$8.375	7.16%	6.35%	$82.0
BRE PROPERTIES INC	N BRE	$36.375	6.60%	12.36%	$287.8
BRT REALTY TRUST	N BRT	$3.750	0.00%	11.11%	$27.5
BURNHAM PAC PROP	N BPP	$17.375	7.83%	9.45%	$153.5
CALIF JOCKEY CLUB	A CJ	$11.500	3.48%	4.55%	$66.4
CALIF REIT	N CT	$2.125	9.41%	0.00%	$19.6
CAPITAL HOUSING	A CAP	$5.375	55.03%	2.38%	$26.8
CAPSTEAD MTG CORP	N CMO	$38.875	8.85%	-0.96%	$565.2
CHICAGO DOCK	1 DOCKS	$11.250	2.84%	18.42%	$65.1
CLEVETRUST RLTY	1 CTRIS	$3.313	3.62%	44.53%	$6.5
CNL REALTY INVEST	1 NNN	$11.875	9.10%	-2.06%	$21.3
COLUMBIA RE INV	A CIV	$8.125	9.35%	4.84%	$34.9
CONT'L MTG & EQ TR	1 CMETS	$6.500	1.85%	4.00%	$21.9
COPLEY PROPERTIES	A COP	$10.750	7.44%	14.67%	$38.5
COUNTRYWIDE MTG	N CWM	$5.750	8.35%	6.98%	$80.4
COUSINS PROPERTIES	N CUZ	$16.750	4.06%	15.52%	$363.7
CRI LIQUIDATING	N CFR	$9.750	11.90%	4.00%	$296.6
CRIIMI MAE	N CMM	$10.250	10.54%	2.50%	$206.9
CV REIT	N CVI	$8.375	11.94%	16.95%	$60.5
DEL-VAL FINANCIAL	N DVL	$1.375	0.00%	83.33%	$9.5
DIAL REIT	N DR	$10.625	8.28%	16.44%	$87.8
DUKE RLTY INVEST	N DRE	$6.125	9.70%	10.00%	$35.4
EASTGROUP PROP	A EGP	$16.875	9.01%	-0.74%	$41.4
EASTOVER CORP	1 EASTS	$4.750	10.53%	-9.52%	$5.4
EQK RLTY INVEST I	N EKR	$2.625	0.00%	5.00%	$19.9
EQUIVEST INC	A EVI	$3.750	0.00%	15.39%	$8.0
FEDERAL RLTY INV	N FRT	$24.625	6.25%	0.04%	$606.0
FST UNION RE INV	N FUR	$9.750	7.39%	6.85%	$176.3
HEALTH CARE PROP	N HCP	$27.000	6.56%	6.93%	$712.3
HEALTH CARE REIT	N HCN	$22.500	8.36%	5.26%	$195.4
HEALTH EQUITY PROP	N EQP	$8.750	11.20%	4.29%	$126.9
HEALTH REHAB PROP	N HRP	$12.500	10.24%	1.01%	$447.0
HEALTHVEST	A HVT	$2.000	0.00%	14.29%	$21.5
HMG/COURTLAND PROP	A HMG	$5.125	0.00%	20.59%	$6.0
HOMEPLEX MTG CORP	N HPX	$2.000	30.00%	-15.79%	$19.5
HOTEL INVESTORS TR	N HOT	$1.375	0.00%	37.50%	$16.7
HRE PROPERTIES	N HRE	$12.375	8.73%	8.77%	$65.5
ICH PROPERTY INVES	N ICH	$2.375	0.00%	-8.00%	$17.2
INC OPP REALTY TR	A IOT	$7.875	2.03%	26.00%	$6.8
INVG MTG SEC CORP	1 INVG	$6.000	13.33%	18.10%	$4.1
IRT PROPERTY CO	N IRT	$13.125	6.40%	7.14%	$250.6
KIMCO REALTY CORP	N KIM	$32.875	5.35%	6.05%	$538.6
KOGER EQUITIES INC	A KE	$5.500	0.00%	18.92%	$72.7
KRANZCO REALTY TRS	N KRT	$23.750	7.74%	12.14%	$182.9
LANDSING PAC FUND	A LPF	$3.625	13.24%	0.00%	$22.3
LINCOLN NC RLTY FD	A LRF	$4.188	9.55%	8.08%	$8.4
LINPRO SPEC PROP	A LPO	$0.563	0.00%	50.13%	$1.0
LNH REIT	N LHC	$9.125	6.14%	2.82%	$20.1
LOMAS NET MTG INV	N LBI	$0.750	0.00%	33.22%	$8.9
LTC PROPERTIES INC	N LTC	$10.625	9.41%	3.75%	$79.7
MEDICAL PROPERTIES	A MPP	$0.250	0.00%	32.98%	$0.6
MEDITRUST	N MT	$30.875	8.07%	0.41%	$912.3
MELLON PART MTG TR	1 MPMTS	$4.250	13.18%	-8.11%	$36.7
MERIDIAN POINT '83	1 MPTBS	$2.000	0.00%	-20.00%	$6.1
MERIDIAN POINT IV	A MPD	$0.438	0.00%	0.00%	$3.3
MERIDIAN POINT VI	A MPF	$1.063	0.00%	-14.96%	$3.7
MERIDIAN POINT VII	A MPG	$1.125	0.00%	5.83%	$4.2
MERRY LAND INVEST	N MRY	$16.250	4.19%	8.33%	$193.3
METROPOLITAN RLTY	A MET	$5.813	12.39%	9.41%	$26.3
MGI PROPERTIES	N MGI	$14.250	5.61%	27.03%	$133.9
MIP PROPERTIES	A MIP	$1.000	0.00%	60.00%	$9.0
MONMOUTH REIT	1 MNRTA	$5.375	9.30%	-4.44%	$12.8
MSA REALTY TRUST	A SSS	$6.125	9.80%	11.36%	$35.6
MTG & REALTY TRUST	N MRT	$1.625	0.00%	30.00%	$18.0
NATIONAL HEALTH IN	N NHI	$26.500	8.57%	9.48%	$189.7
NATIONWIDE HEALTH	N NHP	$33.125	6.94%	1.92%	$544.0
NAT'L INC RLTY TR	1 NIRTS	$5.625	2.13%	9.78%	$18.1
NEW PLAN RLTY TR	N NPR	$23.375	5.43%	-0.76%	$1,131.0
NOONEY REALTY TR	1 NRTI	$5.125	7.81%	7.90%	$4.4
OMEGA HEALTHCARE	N OHI	$21.250	9.42%	1.80%	$129.6
ONE LIBERTY PROP	A OLP	$8.375	8.36%	-4.29%	$11.2
PARTNERS PREF YLD	A PYA	$11.500	8.35%	15.95%	$43.6
PENNSYLVANIA REIT	A PEI	$25.375	6.78%	7.98%	$219.2
PITTS W VA RAIL RD	A PW	$7.125	7.86%	1.79%	$10.8
PRESIDENTIAL RLTY	A PDL A	$6.250	9.61%	0.00%	$2.0
PRESIDENTIAL RLTY	A PDL B	$3.625	11.03%	-12.12%	$10.7
PRICE REIT	1 PRET	$28.500	8.00%	-1.72%	$83.2
PROP CAPITAL TRUST	A PCT	$3.750	7.47%	-6.25%	$33.9
PROP TRUST AMERICA	N PTR	$15.750	4.44%	12.50%	$422.3
PRTNRS PREF YLD II	A PYB	$12.250	6.53%	10.67%	$46.4
PRTRS PREF YLD III	A PYC	$12.625	12.67%	14.51%	$19.2
PRUDENTIAL RLTY TR	N PRT P	$3.125	6.40%	8.70%	$34.8
PRUDENTIAL RLTY TT	N PRT	$0.125	0.00%	-11.35%	$1.4
PS BUSINESS PARKS	A PSB	$14.625	10.94%	7.32%	$7.2
PUBLIC STORAG XVII	A PSV	$9.125	8.99%	7.83%	$33.7
PUBLIC STORAGE IX	A PSK	$14.750	17.02%	13.20%	$31.2
PUBLIC STORAGE VI	A SPF	$18.875	9.33%	3.71%	$54.0
PUBLIC STORAGE VII	A PSN	$13.750	10.47%	11.76%	$43.4
PUBLIC STORAGE X	A PSL	$13.625	10.28%	5.47%	$28.2
PUBLIC STORAGE XI	A PSM	$12.625	10.77%	5.84%	$25.9
PUBLIC STORAGE XII	A PSN	$13.250	9.36%	6.35%	$27.4
PUBLIC STORAGE XIV	A PSP	$13.500	10.07%	1.58%	$35.4
PUBLIC STORAGE XIX	A PSY	$6.375	4.71%	3.92%	$20.8
PUBLIC STORAGE XV	A PSQ	$10.125	8.69%	6.10%	$26.8
PUBLIC STORAGE XVI	A PSU	$11.250	9.24%	1.19%	$41.5
PUBLIC STORAGE XX	A PSZ	$9.250	6.92%	5.56%	$9.5
PUBLIC STORG VIII	A PSJ	$15.000	9.20%	8.42%	$31.4
PUBLIC STORG XVIII	A PSW	$10.250	7.42%	9.90%	$38.0
REALTY REFUND TR	N RRF	$10.000	10.00%	17.65%	$10.2
REIT OF CALIFORNIA	N RCT	$16.500	8.83%	11.85%	$133.1
RESORT INCOME INV	A RII	$10.500	14.29%	12.99%	$37.3
RESOURCE MTG CAP	N RMR	$26.125	13.40%	31.98%	$387.0
ROCKEFELLER CTR PR	N RCP	$8.375	11.94%	9.84%	$316.1
RPS REALTY TRUST	N RPS	$5.125	11.71%	5.50%	$146.6
RYMAC MTG INV CORP	A RM	$5.000	5.00%	-1.46%	$26.1
SANTA ANITA RLTY	N SAR	$18.250	7.45%	6.23%	$205.4
SIERRA CAPTL VIII	A SZN	$0.750	0.00%	-14.29%	$1.2
SIERRA RE EQ TR 84	1 SETC	$0.188	0.00%	20.51%	$0.9
SIZELER PROPERTY	N SIZ	$11.750	8.85%	6.82%	$55.7
STORAGE EQUITIES	N SEQ	$10.000	8.40%	12.68%	$149.9
STORAGE PROPERTIES	A PSA	$5.625	17.78%	4.44%	$18.8
SW PROPERTY TRUST	A SWP	$12.375	6.46%	18.12%	$17.5
TAUBMAN CENTERS	N TCO	$13.000	6.77%	12.47%	$529.0
TIS MORTGAGE INV	N TIS	$3.625	5.52%	13.08%	$29.4
TRAMMELL CROW RE	N TCR	$2.125	7.53%	6.25%	$19.3
TRANSCONT'L INVEST	N TCI	$7.875	0.00%	16.67%	$23.8
UNITED DOMIN REIT	N UDR	$26.125	5.05%	4.77%	$460.8
UNIVERSAL HEALTH	N UHT	$15.375	10.67%	0.82%	$108.4
USP REIT	1 USPTS	$2.000	12.00%	23.08%	$7.8
VANGUARD RE FD I	A VRO	$6.875	13.96%	7.84%	$77.3
VANGUARD RE FD II	A VRT	$6.125	9.80%	11.36%	$40.4
VINLAND PROPERTY	1 VIPTS	$0.313	0.00%	0.00%	$1.9
WASHINGTION REIT	A WRE	$20.875	6.02%	3.73%	$588.9
WEINGARTEN RLTY	N WRI	$37.375	5.39%	3.41%	$712.4
WELLSFORD RES PRTR	N WRP	$24.625	6.82%	4.91%	$145.7
WESTERN INV RE TR	A WIR	$14.625	7.66%	18.18%	$240.5
WETTERAU PROPERTY	1 WTPR	$19.250	6.13%	6.94%	$25.9

NOTE: Data is provided only for REITs listed on the New York Stock Exchange, American Stock Exchange and NASDAQ National Market System. Additional REITs with opportunities for investors to invest may be found in the REIT Sourcebook

TESTIMONY OF MARK GOLDBERG, DIRECTOR OF DUE DILIGENCE FIRST VICE PRESIDENT OF ROYAL ALLIANCE ASSOCIATES, INC.

EXECUTIVE SUMMARY

The eyes of many people, including general partners planning rollups, their attorneys and accountants, are on the activities of this Subcommittee and the progress of Senate Bill 424 and House Bill 617. Only the actions of the California Department of Corporations, in my opinion, have stopped a flood of rollup activity. Pending the enactment of this legislation and adoption of rules, California Department of Corporations may no longer be an obstacle to abusive rollups. It is therefore imperative for this legislation, and guidelines to follow, to be comprehensive. Otherwise, I fear the intent of this committee to protect investors will be eluded. It is time to address a national problem on a national basis.

The current NASD proposal and California actions have been very helpful but are not sufficient to fully protect investors. Most importantly, there is substantial precedent in Federal law for regulating the activities of fiduciaries in their dealings with investors. General partners are such fiduciaries.

INTRODUCTION

Mr. Chairman and Members of the Committee: Good afternoon, my name is Mark Goldberg, Director of Due Diligence and First Vice President of Royal Alliance Associates, Inc. Royal Alliance is a subsidiary of SunAmerica, Inc., a diversified financial services company. SunAmerica and it's broker-dealers have over 3,500 registered representatives in 50 states. These representatives come from a diverse background and many sold interests in a variety of limited partnerships over the years. In the current era of rollup proposals these representatives look to their broker-dealer for guidance. Though Royal Alliance may not have directly sold interests in all the partnerships which have been the subject of rollup proposals, our representatives have had clients affected by many proposals to rollup public partnerships and are likely to have clients in many future proposed rollups. While I appear before you in my individual capacity and not as a representative of my Company, the matters before this Subcommittee impact my professional activities on a continuous basis.

Given my interest in the subject I thank the Subcommittee for the opportunity to testify and applaud the Subcommittee for its interest in protecting a category of investors in desperate need of protection. The eyes of many people, including general partners planning rollups, their attorneys and accountants, are on the activities of this Subcommittee and the progress of Senate Bill 424 and House Bill 617. Only the actions of the California Department of Corporations, in my opinion, have stopped a flood of rollup activity. Pending the enactment of this legislation and adoption of rules, California Department of Corporations may no longer be an obstacle to abusive rollups. It is therefore imperative for this legislation, and guidelines to follow, to be comprehensive. Otherwise, I fear the intent of this committee to protect investors will be eluded. It is time to address a national problem on a national basis.

I. TRENDS IN ROLLUP ACTIVITY

As you are aware, "rollup" transactions, wherein a number of previously independent partnership are merged to a new form of entity, have received a large amount of generally adverse publicity and criticism from the press and government officials in recent years. This has resulted in the presentation of the pending Federal legislation, the proposal of amendments to the Rules of the National Association of Securities Dealers, Inc. ("NASD") which are currently pending approval at the Securities and Exchange Commission ("SEC"), proposal and enactment of new rollup rules by the North American Securities Administrators Association ("NASAA") and amendments to the NASAA Real Estate Program Guidelines, the issuance of an SEC interpretation of the disclosure required in connection with rollup transactions (SEC Release No. 33–6900, June 17, 1991), the amendment of Regulation S–K by the SEC to set forth specific disclosure requirements for rollup transactions (17 C.F.R. §§229.900 *et. seq.*) and the passage in California of the Partner Protection Act which amended Sections 25100, 25103 and 25120 of the Corporations Code and added Sections 25014.5, 25014.6 and 25014.7 to the Corporations Code. In spite of this legislative activity, the interest of general partners in rollups has not waned. To the contrary, the strong market for real estate investment trusts and the interest on Wall Street in new real estate investment trust equity and debt transactions has intensified the desire of sponsors to engage in rollup transactions.

The majority of existing unlisted public and private limited partnerships are involved in real estate. Rollups of these entities will proceed in great volume limited only by the cost and regulatory barriers. The reasons are obvious.

General partners are, or owned by, human beings who can be expected to act in their own economic interest. Although the limited partners were sold their investment with the understanding that the partnerships would have a finite life, general partners, naturally, do not want to give up control of the partnership's assets, and the revenues they generate in fees and reimbursement of overhead. This is especially true since the decline in the—real estate market has generally left general partners with no prospect to share in any sales proceeds based on the subordinated interests they originally received. It is on this backdrop they face the sobering reality that their businesses are stagnating with fewer and fewer opportunities for growth.

The incentives for general partners to attempt rollups are many. Rollups allow general partners to obtain control of stock exchange listed real estate investment trusts ("REITs"), which are currently in great favor on Wall Street. Such listed REITs can raise money and increase assets under the control of the former general partner, something the partnership syndicator can generally no longer achieve. Further, before the California rollup legislation, the general partner in a rollup could obtain fees and participation in the ownership of assets that the general partner was not otherwise entitled to under the partnership agreements.

Rollups can also benefit limited partners. Short of the sale of properties and distributions of any cash proceeds, the rollup into a REIT may offer the limited partner the best hope for liquidity after 5 to 10 years in a generally illiquid investment. While limited partnership interests trade sporadically and at deep discounts in the secondary market, REIT shares listed on an exchange, at least for now, trade, on average, at net asset value or a premium. While the rollup may create adverse tax consequences, it at least gives the limited partner the ability to liquidate at or near current value. Most critically, a rollup today can enhance the value of assets and cash flow by allowing a significant reduction in the cost of debt. This ability to reduce the cost of debt is a result of the REIT's ability to raise new equity to pay down debt and then to directly or effectively cross collateralize its assets and securitize the remaining debt at the favorable rates now available. Absent a rollup, such refinancing is generally not possible.

II. CURRENT AND POTENTIAL PROBLEMS WITH LIMITED PARTNERSHIP ROLLUPS

The basic problem with rollups, absent regulation to prevent abuse, is that the general partner may extort benefits for itself as the price of providing the benefits of a rollup. Without regulation, general partners may present a complex rollup to limited partner which includes significant benefits for the general partner at the expense of the limited partners. The limited partners must vote on the entire package on a "take it or leave it" basis.

The limited partners may not be sophisticated investors. There is no exchange listed trading market with professional investors to judge the proposals. The nature of the general partner's control, including the ability to deny transfer of limited partnership interests, makes it difficult for alternative proposals to be made. Rollup transactions involve basically untraded securities and entities which exist outside the scrutiny of the public market. Similar transactions involving trading securities would have to deal with professional investors and arbitrageurs, possible opposing offers and the market's immediate price reaction to any proposal. Rollup transactions, on the other hand, have taken place with one sided solicitations by high pressure professional solicitation firms contacting generally uninformed investors. These solicitation firms are usually not broker-dealers and are basically unregulated. Their high pressure telephone calls are the key moment in the investors solicitation, especially since the rollup prospectus, despite the commendable efforts of the SEC, remains indecipherable to the untrained investor, and sometimes difficult even for the trained professional. To date, the natural obstacles inherent in the situation have left few ways to effectively or economically organize any opposition or counter-proposals. There is no effective way to counter the unregulated pressure tactics of the solicitation firm given the expense of a counter solicitation and the obstacles to success of hostile proposals.

Absent regulation, there is no effective way to force the general partner to live up to its original promise and legal obligation to act as a fiduciary, solely in the interest of the limited partners, to liquidate the properties at some point and not to deal in its own interest at the expense of the limited partners.

III. GAPS AND AMBIGUITIES IN CURRENT LAW AND PROPOSALS

A. CALIFORNIA LAW AND THE PROPOSED RULES OF THE NASD WHILE VERY HELPFUL DO NOT PROVIDE COMPLETELY ADEQUATE PROTECTION FOR INVESTORS

Prior to the adoption of the Partner Protection Act in California, Section 25100(o) of the California Corporations Code exempted transactions from the review of the Commissioner in the permit qualification process where the securities to be issued were "listed or approved for listing" on a designated stock exchange. The amendment to Section 25100(o) of the Corporations Code in the Partner Protection Act removed the availability of this exemption for rollup transactions. The exemption is no longer available for a "rollup transactions" unless the rollup transaction is an "eligible rollup transaction" as defined in Section 25014.7(a) of the Corporations Code. In order to be an "eligible rollup transaction," the rollup entity would have to have its securities listed or accepted for listing on an exchange both certified by the Commissioner *and* which had established detailed procedures to protect limited partners in rollup transactions. Since there are currently no—exchanges that qualify, any rollup transaction subject to the jurisdiction of California must obtain a permit.[1] As of now, there is no clear procedure for the Commissioner to certify that the protective procedures adopted by an exchange satisfy the procedures outlined in the Partner Protection Act.[2]

One obvious difference between the NASD proposals and the Partner Protection Act is that the Partner Protection Act does not contemplate that the dissenter's right outlined in the Act can be avoided or waived based on a broad concept of "comparable rights," a concept which is included in the NASD proposals. This means that I do not know if the NASD proposals will or will not result in an exemption in California for rollups accepted for listing on NASDAQ NMS. If the NASD proposals eliminate the scrutiny of the California Department of Corporations, the "comparable rights" provisions of the NASD rules become a method to by which sponsors can avoid the imposition of dissenter's rights by regulators in California and avoid the dissenter's rights otherwise provided for in the NASD rules. This is a very serious gap and limitation on current investor protection.

The NASD proposals contain three specific "comparable rights" which may replace dissenter's rights to cash or marketable securities in a rollup. These are: (i) a 75 percent approval requirement; (ii) review by an independent committee; or (iii) any other comparable right accepted by the NASD. The last comparable right is objectionable since it is the equivalent of having no definitive standard. The 75 percent vote requirement is not objectionable since it could be rarely used in any broadly held partnership. The independent committee concept is well intentioned. However, given the liability which no indemnification could fully protect against, the time and expertise required, and the difficulty in identifying a truly independent committee, with the incentive to do the work it is probably impractical. It is unfortunately likely that any such committee will be compromised and wholly ineffective. A review committee should not be a replacement for strong dissenter's rights to a cash or cash equivalent buyout.

The NASD proposals only apply to rollup transactions in which an NASD member participates or listing is sought on NASDAQ Rollup sponsors can easily avoid either requirement by listing on other exchanges, using unregulated solicitation firms and using appraisers licensed as investment advisers or others who are not members of the NASD. This is a serious gap in investor protection.

B. GENERAL PARTNER AFFILIATES SHOULD NOT PARTICIPATE IN A ROLLUP

California law and the NASD proposals provide a detailed specific procedure for valuation of a general partner's interest in the rollup partnerships, but are silent on the valuation of other assets or entities that the general partner may seek to include in the rollup. Such silence can be interpreted to mean that other entities

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[1] There are certain possible exemptions still available for institutional, private or other limited transactions. See California Corporations Code § 25100 and Commissioner Rule § 260.103.

[2] Contrary to the understanding of many, the Partner Protection Act does not contain the standard mandated by statute that the Commissioner in California must apply in reviewing a permit application related to a rollup transaction. In reviewing a permit application related to a rollup, the Commissioner may deny recapitalization or reorganization and the proposed issuance of securities are fair, just and equitable to all security holders affected. Corporations Code § 25140(c). This standard is subject to extremely broad interpretation. Apparently, the Commissioner in practice will look to the Partnership Protection Act for guidance as to what is fair, just and equitable, but it also appears that the Commissioner will also look to California's real estate and general merit guides and policies in reviewing a permit application related to a rollup. However, since there are no definitive written standard specifically for rollups, I cannot look to the California Commissioner as a replacement for definitive Federal standards.

or assets may not be included, and this appears to be the initial conclusion reached by the Department of Corporations in California.

This is a very important current issue as general partners seek to include their management company in rollups in exchange for millions of dollars of participation in the rollup assets. The stock market currently seems to place a premium on self advised REITs. The general partner usually has an affiliate receiving management fees for managing the partnership properties. These management contracts are generally terminable on limited notice without compensation by the partnerships under the original conditions imposed by state regulators and under terms of the original offering. The current issue is whether the general partners can make the rollup entity buy these contracts for large cash value even though they could be terminated without payment. They do not seek to do this directly but by including their management company in the rollup, valued primarily on the basis of these terminable contracts. This is a perfect example of extorting concessions as a condition to a rollup—making limited partners pay millions of dollars to purchase the value of management contracts they had the power to terminate without payment.

I believe it should be made clear that the purchase of assets other than interests in the rollup partnerships themselves should be left for a separate vote or a vote after the REIT is a trading entity and should not be a condition of a rollup. This would require the approval of independent trustees—or directors and be tested in the full view of an active trading marketplace.

C. ROLLUP LEGISLATION SHOULD NOT PREVENT LIMITED PARTNERS FROM OBTAINING BETTER OFFERS

Most current law and proposals seem to draw no substantive distinction between proposals of a current general partner and unaffiliated entities.[3] Rollup legislation should be designed to protect limited partners from the general partner because: (i) the general partner is a fiduciary to the limited partners and has a conflict of interest; (ii) the general partner controls access to the limited partners and partnership information; (iii) the general partner has certain powers under the partnership agreement which makes it difficult for others to tender for limited partnership interests; (iv) the general partner may access the partnership's funds to pay for planning and effecting its proposal; and, perhaps most critically, (v) because there is generally no one involved in a general partner proposed rollup with the resources, interest and practical ability to protect and advise the limited partners. While unaffiliated parties should be held to disclosure standards, rollup legislation will not help limited partners to obtain maximum value if it is a barrier to unaffiliated parties proposing alternatives to a general partner proposed rollup. When an unaffiliated party makes a proposal, the general partner is there to advise and protect the limited partners. In addition, unaffiliated parties are not fiduciaries with the advantages of the general partner to control the partnership and access to partnership funds. Rollup legislation should encourage the presentation of all competing offers to the limited partners, and not prevent it. Current legislation and proposals do not achieve this goal. The cost of presenting a competing offer, which I have heard estimated to be a minimum of three to four million dollars, is already a major barrier to limited partners getting the maximum possible price.

For these reasons I believe that general partners should be required, if they propose a rollup, and possibly even if they do not, to communicate to limited partners all alternative rollup or tender offer or property sale offer proposals, to negotiate in good faith concerning such proposals and to not use any authority they may have,

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[3] Section 2(b)(13) of the proposed amendments to Appendix F of the Rules of Fair Practice of the NASD excludes from the definition of a "Rollup" a "proposal by an independent, non-affiliated third party to succeed to a general partner(s) . . . interest that is approved by 66⅔ percent of the investors" as long as the general partners do not get more compensation than provided for in the partnership agreements. The NASD explained that this exclusion was justified because "such a transaction is closer to a hostile acquisition by a third party . . . than to a rollup transaction as intended to be covered by the proposed rule change. In such situations, the limited partners have a bonafide choice of tendering or exchanging their shares. . . ." NASD submission to the SEC at page 32 (January 28, 1993). While I agree with the reasoning of this exclusion, I am concerned about the other implications of the language taking away rights that limited partners currently have pursuant to partnership agreements. Partnership agreements often provide for the removal of a general partner by the vote of a mere majority of the limited partners. While I don't think that it was the intent of the NASD, some might interpret this section to mean that a mere move to remove the general partner of any number of partnerships by a simple majority vote is a "Rollup" it may restrict existing rights of limited partners. If the intent of the section is to exclude tender or rollup proposals by unaffiliated parties accompanied by removal of the general, as long as there is payment of no more than the contractual amount due to the general partner, then the language excludes all hostile tenders and I both agree with the language and think the exclusion should be clarified and included in the Federal legislation.

such as authority to deny the transfer of ownership of limited partnership interests, to block alternate proposals that the limited partners indicate they would prefer. For the same reason I believe that the definition of a rollup should clearly exclude a cash or cash equivalent tender for all or part of the limited partnership interests by a party independent of the general partner. For this purpose a cash equivalent tender should include a tender using a seasoned security trading on a major exchange. In these situations, the existing tender offer regulatory scheme and the general partner are sufficient to protect the limited partners and assure that they are properly informed. This will assure that limited partners have the benefit of the market to obtain the best price possible.

It is for the same reasons rollup proposals should not be allowed to include anti-takeover provisions in the rollup entities organizational documents.

D. General Partners Should Not Be Allowed To Engage In Self Dealing That Would Have Been Prohibited With The Partnerships

Partnership agreements of public limited partnerships generally prohibit a variety of self dealing transactions, including the lending of partnership assets to the general partners. In at least one recent rollup proposal, the general partner sought multi-million dollar non-interest bearing loans from the rollup entity. It was argued that these loans were necessary to allow the general partner to pay liabilities involved in making up its negative capital account pursuant to the partnership agreements. Of course, no one proposed non-interest bearing loans to the limited partners to pay their tax liability resulting from the proposed rollup. I believe that approval of self dealing transactions with the fiduciary general partner should not be required of limited partners as a condition of a rollup.

E. Independent Appraisals Of The Assets Of All Partnerships Are Required To Inform And Protect Investors

Senate Bill 424 requires appraisal rights for dissenter's but does not require an appraisal of assets in all partnerships. A full appraisal of all assets is necessary not just to protect dissenter's but to protect and inform all limited partners in an area where the general partner has an inherent conflict of interest. The general partners conflict arises in at least two specific circumstances.

First, in order to protect itself from liability, a general partner may seek to bail out a partnership that has no equity left and cannot pay debts by rolling it up with stronger partnerships and may make the representations necessary to achieve this end. Second, a general partner has an incentive to maximize the shares in the rollup entity attributable to partnerships in which the general partner has a greater percentage interest. This creates an incentive to overvalue the assets of those partnerships and undervalue the assets of others to maximize the general partner's share of the rollup entity. Again, this was viewed by many to have occurred in a previous rollup. Truly independent and qualified third party appraisals help to prevent abuses of this nature.

F. Limited Partners Need Better Advice On The Trading Activity Of Rollups

Limited partners often sell their shares in the rollup entity in the early days of trading when the selling pressure assures they receive a poor price. Rollup documents should provide clear disclosure of these historical trends so limited partners can make informed decisions.

IV. SUBSTANTIVE REGULATION IS JUSTIFIED WHEN FIDUCIARIES DEAL WITH ASSETS OF INVESTORS

I have heard the thought expressed that any restriction on the ability of 51 percent of the limited partners to agree with the general partner on a rollup is an interference with the right to contract. That is a spurious argument. When the original public partnership was sold, a prospectus and partnership agreement was completed with the involvement of state and Federal regulators. The original agreement, as required by state guidelines and also as provided by state common law, expressly provided, and represented to investors, that the general partner was a FIDUCIARY bound to act in the interests of limited partners. The fiduciary duty of a general partner to limited partners is one of the HIGHEST GOOD FAITH and is the equivalent of the duty of a trustee under a trust agreement. It is a violation of that duty for a fiduciary to demand benefits for itself in order to fulfill its duty to act for the limited partners. Such a duty is not waivable, even if it is couched in terms of amending a contract.

For over 50 years Congress has seen the need to regulate those who have a fiduciary or other special relationship with an investor's assets, irrespective of any consent of the investor. The Investment Company Act of 1940 regulates the actions of sponsors in respect of mutual funds and other investment companies. The Invest-

ment Advisers Act regulates how investment advisers deal with clients. The Securities Exchange Act of 1934 governs how broker-dealers deal with clients. The Trust Indenture Act deals with how trustees must act under trust indentures that govern most debt offerings. The Employee Retirement Income Security Act of 1974 governs how all manner of fiduciaries and parties in interest deal with pension assets. The general partner fiduciary of a public partnership may be a rare exception as a federally unregulated fiduciary dealing with the assets of public investors.

WRITTEN TESTIMONY OF A. DOUGLAS PEABODY

President, Meigher, Peabody & Company, Inc.

Chairman Dodd and Members of the Subcommittee: I am pleased to have the opportunity today to appear before the subcommittee to give testimony as to one particular issuer's experience with the limited partnership rollup legislation originally proposed in June 1991 by the Chairman as S. 2226 which is now before the subcommittee as S. 424, as well as the regulations adopted by the Securities and Exchange Commission in October 1991, or proposed by the National Association of Securities Dealers and the various exchanges during 1991 and 1992. Similar legislation was introduced in the House of Representatives by Congressman Markey which I believe passed as H.R. 1885 in November 1991.

I am here today representing Houston Biotechnology Incorporated ("HBI") of The Woodlands, Texas, nears Houston, in my capacity as a member of the Board of Directors. I should point out that I am also a shareholder of HBI as well as a limited partner of Houston Biotech Partners, L.P., a $27 million research and development limited partnership affiliated with HBI (the "Partnership"). Throughout 1991 and the better part of 1992, HBI and Houston Biotech Partners, L.P. were engaged in the process of combining those two legal entities for the mutual benefit of the shareholders of HBI and the limited partners of the Partnership. Coincidentally and somewhat unfortunately, our efforts ran headlong into the legislative and regulatory efforts to curb abusive partnership rollups. While our transaction was quite straightforward by most everyone's objective standards, since it involved only the exchange of interests in a single partnership for common stock of a single related entity, we nonetheless got caught up in the regulatory web like the proverbial mouse in the dance of elephants.

Prior to my present position in my own investment management firm, I was with Inco Venture Capital Management for eleven years, most recently as President and Managing Principal. IVCM, as we called it, has provided seed and early stage capital for many businesses in the United States since 1974. IVCM provided capital to well over 125 companies across many industry sectors including many companies in the biotechnology industry which have become publicly held companies. Among the companies we funded were Genentech, Inc., Biogen, Inc., ImmunoGen,Inc., The Liposome Company and SCIOS-NOVA. Many of these companies used the R & D Partnership as financing vehicles and have subsequently rolled them up without incident.

In the typical biotechnology company, the development process is long, regulated, risky and very expensive. A successful company will go public and create liquidity for its shareholders before it produces any revenue. Partnerships may be employed along the way as vehicles to insulate the company from the total risk of development of a particular drug while giving investors an opportunity to invest in a high risk/high reward type of situation. In some cases, as with the case of HBI, the illiquid Partnership vehicle is used to raise large sums of patient capital needed for drug development directly from high net worth individuals without having to take on the volatility of the public markets. Since most of these partnerships anticipate that the company will go public before the partners are likely to share in any revenue or income stream, they generally provide for some kind of rollup mechanism involving an exchange for company stock. In buoyant public offering markets for biotechnology issues, the take out can be automatic. When markets turn sour, as they did in 1987, the rollups may have to be negotiated. This was the case with HBI's Partnership.

HBI was founded in 1984 by two professors at Baylor College of Medicine. The Company is engaged in the research and development of biopharmaceutical products for the prevention and treatment of ophthalmic and neurological disorders. Its flagship product is an immunotoxin for the prevention of secondary cataract. HBI was funded in 1986 with initial capital from my old firm and with $27 million in R & D limited partnership funds raised publicly in 1987 through the direct investment group at E.F. Hutton. The partnership was successful in the sense that the immunotoxin development progressed from the laboratory through preclinical trials into Phase I human clinical trials pursuant to an INDA with the FDA. However,

it became increasingly clear that much more money was going to be required. For various reasons which I will not dwell on here, the Partnership, which owned most of the rights to the project, had no provision or capability for raising additional capital. The company, wherein the expertise to develop the project was resident, was not capable of raising additional capital to complete the development until the complex nature of the relationship with the Partnership was sufficiently simplified.

Consequently, a combination was proposed by HBI management and the independent General Partner of the Partnership. It was approved by the HBI Board of Directors and by the HBI shareholders in July 1991, the month after the SEC proposed its new rules on rollups. An S-4 Registration Statement was filed with the SEC on July 3, 1991, which due to the confusion over the rollup rules, did not become effective until February 20, 1992, nearly eight months later. The transaction was closed on April 30, 1992, with 76 percent of the units voting in favor and only 3 percent voting against. Our rollup cleared blue sky in 46 states. I am told that HBI was the first partnership rollup to become effective under the new SEC rules.

Earning that distinction cost the company and the limited partnership nearly $1 million in expenditures relating to the registration process, a figure approximating 12.5 percent of the combined entities then tangible net worth, endless amounts of management time and the opportunity cost associated with missing the biotechnology window in the new issues market which opened at the end of 1991 and then closed abruptly again before the end of the first quarter of 1992.

There can be no doubt that the regulations relating to partnership rollups proved very costly to HBI and the Partnership. Ironically, an argument can be made that the legislation and the regulation ought not to apply to biotechnology R & D partnerships at all. As far as I know, biotechnology R & D partnership rollups have not suffered the abuse attendant oil and gas and real estate partnerships and in my discussions with committee staffers no one has pointed out to me any evidence to the contrary in the legislative record.

Having passed one rollup registration through the SEC under the new rules, I am inclined to believe that those rules sufficiently address the problem. Although I am not an expert on the legislation under discussion today, I am told that, in addition to what the SEC rules require, the legislation would require Registered Securities Associations such as the NASD, National Securities Exchanges such as the AMEX, and Automated Quotation Systems such as the NASDAQ to prohibit participation in or listing of rollup transactions which do not offer dissenters' appraisal rights, among other things.

We did not offer dissenters' appraisal rights in our transaction for the simple reason that they were not appropriate. The Partnership was organized for a fixed term to engage in research and development with no expectation of cash distributions for quite some time. A conversion to stock ownership was contemplated and the rollup was the best means to an earlier liquidity event for all limited partners. To have depleted partnership cash to satisfy dissenters would have been unfair to the majority of partners wishing to continue in reorganized form.

We did not distribute the common stock issued in connection with the rollup to our limited partners because the stock was not underwritten and we did not have a listing. We wished to pursue both an underwritten offering and a listing before we distributed the stock. As part of the last series of comments which we received from the SEC, we were informed that the stock had to be distributed within one year from the transaction date or the Company would also have to comply with the Investment Company Act. Consequently, we began pursuing a listing with the American Stock Exchange. At the time, the Exchange was requiring compliance with the Markey bill which required dissenters' rights, potentially barring the company from the listed exchanges, a result which we felt was not in the best interests of limited partners nor warranted under the circumstances. Thus, we do not believe that the dissenters' rights provisions were or are necessarily appropriate to this kind of a rollup.

In summary, we believe it is important in considering this legislation to take into account the regulatory burden to small issuers such as Houston Biotechnology as well as the chilling effect that special requirements of such legislation, including a bar from listing for not including dissenters' rights in transactions, would have on the use of the partnership vehicle for financing emerging biotechnology companies. On the other hand, we also believe that anything Congress can do to preempt State legislation in this area and clarify the rules would be beneficial to issuers and investors alike.

Thank you.

APPENDIX A

CHRONOLOGY OF THE COMBINATION OF HOUSTON BIOTECH PARTNERS, L.P. AND HOUSTON BIOTECHNOLOGY INCORPORATED

February 27, 1991—Hearings before the Senate Subcommittee on Securities on Limited Partnership Rollups.

June 17, 1991—SEC Release Nos. 33–6899 and 33–6900 proposed.

June 1991—S. 2226—1992 Limited Partnership Rollup Reform Act introduced by Senator Dodd.

July 3, 1991—HBI and HBP file initial registration statement proposing a restructuring of HBI and combination with HBP.

July 18, 1991—HBI stockholders approve the restructuring and combination with HBP.

August 9, 1991—15 page SEC comment letter received containing 91 comments. Staff requests that the document be revised in accordance with Securities Act Release No. 6899 and Rule 421(b).

September 30, 1991—Amendment No. 1 filed with the SEC.

October 25, 1991—4 page SEC comment letter received containing 17 comments. SEC indicated that while substantial effort had been made to comply with SEC Release Act No. 6900 and Rule 421(b), substantial additional revisions were necessary.

October 31, 1991—Proposed SEC rules go into effect under Release No. 33–6922.

November 6, 1991—H.R. 1885 introduced in the U.S. House of Representatives.

November 15, 1991—Amendment No. 2 filed with the SEC.

December 27, 1991—10 page SEC comment letter received containing 55 comments. SEC provided specific comments and no longer referred to "substantial revisions" under Securities Act Release No. 6900 and Rule 421(b).

December 31, 1991—HBI responds to the SEC proposing a meeting, noting the apparent backward movement in getting the registration statement approved. The SEC indicates that no meeting is necessary.

January 20, 1992—Amendment No. 3 filed with the SEC.

January 31, 1992—8 page SEC comments letter received containing 43 comments.

February 1, 1992—HBI responds to the SEC urgently proposing a meeting, noting that this registration statement has become a test case for Release No. 33–6922.

February 10, 1992—Amendment No. 4 filed with the SEC.

February 12, 1992—HBI meets with the SEC (some 17 interested parties attend) and the SEC raises for the first time the Investment Company Act issue.

February 14, 1992—2 page SEC comment letter received containing 12 comments.

February 18, 1992—Final Amendment No. 4 filed with the SEC, bringing total filings to 6.

February 20, 1992—Registration statement declared effective.

April 30, 1992—Rollup transaction completed.

December 23, 1992—HBI files S–1 registration statement with the SEC covering a rights offering of HBI common shares. American Stock Exchange agrees to list HBI shares upon satisfactory completion of the offering.

February 16, 1993—HBI files Amendment No. 1.

March 20, 1993—HBI files Amendment No. 2.

April 5, 1993—HBI files Amendment No. 3.

April 15, 1993—HBI files Amendment No. 4, which is declared effective 9:15 am EST.

TESTIMONY OF CHARLES K. BARBO

CHAIRMAN, SHURGARD INCORPORATED

Mr. Chairman: I thank you for the opportunity to speak to the distinguished members of this subcommittee regarding S. 424 "The Limited Partnership Roll-up Reform Act of 1993." Let me state at the outset my support for this important legislation and the protection it would afford limited partners from abusive applications of the roll-up process. I believe that this legislation, along with the new NASD rules, will restore the credibility of the roll-up alternative for limited partnerships that has been pummeled by blatant general partner abuses. This legislation will also strike a blow to predatory secondary market makers in limited partnership units that have touted these abuses to scare limited partners and their financial advisers, and protect their lucrative niche. I believe this bill will greatly benefit limited partners and curtail potential abuses of the roll-up process.

As we all know, there is nothing inherently wrong with a roll-up of limited partnerships. It is merely another legal and financial structure. If the financial and regulatory climates are right, it may be the most prudent alternative to protect and enhance the original investment of the individual limited partners. However, many

roll-ups done in the mid-to-late 1980's were done the wrong way and for the wrong reasons. Many of these roll-ups were done to protect the general partners from liability caused by insolvent partnerships. Healthy partnerships were merged with unhealthy partnerships to the detriment of limited partners. Additional fees were often included. In one of the most abusive cases, the real estate assets were stripped off by the general partner and the limited partners were given unsecured junk bonds in a soon-to-be bankrupt savings and loan. The laudable goal of S. 424 is to prevent these abuses from occurring in the future.

Let me give you some background on my experience in the real estate and limited partnership industries. I am one of the General Partners of more than 20 Shurgard limited partnerships formed between 1978 and 1992, representing over 80,000 individual limited partners and $700 million in original investor capital contributions. These partnerships own over 200 self-storage centers throughout the United States. All of our partnerships are financially sound. None of our public partnerships have more than approximately 20 percent debt, with the average being only about 5 percent. We have a record of unbroken quarterly distributions since 1980.

Our company has a specific mission statement and written statement of values which govern our relationships between ourselves, our employees and our limited partner investors. This "Shurgard Constitution" governs all of our actions as a company and it puts the investor first.

We are currently in registration with the Securities and Exchange Commission with a proposal to consolidate 17 of our public limited partnerships. This proposed consolidation is structured consistent with our value system and with the rules in S. 424 "The Limited Partnership Roll-up Reform Act of 1993." None of the abuses that have been detailed in testimony before this committee are part of our transaction. All of the 17 partnerships contain healthy income-producing self-storage facilities with very low levels of leverage. We are not combining healthy partnerships with unhealthy ones. No new fees or payments will be made to the general partners for sponsoring the consolidation. The limited partners voting rights will be the same or, in some ways, greater after the consolidation, and the general partners will own only the same percentage of the deal after the consolidation as before.

Shurgard will recommend the roll-up to our investors because we believe the limited partners will get more for their shares in a REIT than they would get if we liquidate the underlying real estate either now or in the foreseeable future. REITs may very well become the dominant form of real estate ownership and finance during the 1990's because traditional sources of real estate capital are reluctant to reenter the field. As a December 7, 1992, article in Barron's pointed out, equity REITs are now trading *above* the value of the underlying assets. The result of this phenomenon is currently that Wall Street is paying more for real estate assets than traditional real estate purchasers. REITs are popular today for two reasons. First, interest rates are low and REITs offer very competitive current rates of return. Second, the market believes that real estate values are at the bottom of a cycle and there is substantial capital appreciation opportunities in the future. I believe the market is correct in this assumption and these trends will continue. In today's market place, general partners should at least be considering consolidating partnerships into some structure that will create freely-tradable securities. In my opinion, if they are not, they are not acting in the best interests of limited partners.

As I mentioned above, Shurgard is supportive of S. 424. We are also supportive of the bill passed by the House of Representatives with one important exception, the House bill contains a moratorium on roll-ups. This proposed moratorium is unnecessary and unwise.

The moratorium is unnecessary in that the SEC published new rules governing roll-ups in June of 1992. These rules are consistent with the aims of the proposed legislation and the SEC is vigorously enforcing them. The moratorium is unnecessary also because the state of California has recently adopted roll-up legislation which accomplish essentially the same thing as the proposed Federal rules. The California rules have some flaws but they do apply to any partnership that has at least one limited partner living in California. Very few, if any, roll-ups would not be subject to California rules. A third reason is the stock exchanges are requiring those who propose listing of the consolidated shares of consolidated securities to clear California and to prove compliance with the proposed Federal rules. This mention of California is not to suggest that Federal rules are not appropriate, they are. This is meant to suggest that the moratorium is inappropriate.

A moratorium would be unwise in that limited partners could be denied access to liquidity precisely during the best time to achieve it. If a roll-up complies with the substantive regulation put forth in the bill, you should not allow it to be prevented. It would be horribly ironic if action by Congress hurt the very people that they are trying to protect. What we are currently faced with is a classic horse out

of the barn situation. The bad roll-ups that have polluted the environment have already been accomplished. Because of efforts by you and others, the roll-ups of the future will be done in a fair way.

Federal rather than State regulation is appropriate for roll-ups. Most large limited partnerships that will be rolled up in the future have investors in most if not all states. General partners who recommend roll-ups will have to comply with specific rules and offer specific choices to limited partners, these are compliance and disclosure issues. I strongly suggest that you pass preemptive Federal legislation. This would foreclose states from passing rules that are possibly not in the best interests of limited partners. California has done just that in its prohibition of management companies being merged into REITs at the time of the consolidation.

As I mentioned earlier, we are currently in registration with the SEC for a proposed roll-up. I am aware that other general partners are also contemplating a roll-up in order to take advantage of the current favorable market. In my opinion, a fair, profitable and positive consolidation of partnerships can be accomplished under the terms of the proposed legislation.

I thank you for your time and applaud you for your work. Your efforts will go a long way toward helping limited partners and restoring the credibility of roll-ups and the limited partnership industry.

TESTIMONY OF PHILIP S. COTTONE

CHAIRMAN, DIRECT PARTICIPATION PROGRAMS COMMITTEE, 1991–92

VICE CHAIRMAN, BOARD OF GOVERNORS, 1992

NATIONAL ASSOCIATION OF SECURITIES DEALERS

I am Philip S. Cottone, 1991 and 1992 Chairman of the National Association of Securities Dealers, Inc. (NASD) Direct Participation Programs Committee, which developed the NASD's rules on rollups. Until January 1993, I was Vice-Chairman of the NASD Board of Governors. I am pleased to have this opportunity to appear before you to discuss the regulation of limited partnership rollups.

Your invitation letter generally asked us to describe the need for the legislation and the adequacy of the current regulation of rollups. More specifically, you asked that we address the current and potential problems with rollups, any potential gaps in Federal and state law, and the NASD's proposed rules.

We applaud the Subcommittee's concern with the important problems that abusive rollups can present for the investing public. We are also greatly concerned with those problems, and, as we discuss below, have taken a number of important steps to halt those abuses. We believe that rollups that are fairly done can provide important liquidity and economies of scale to partnerships in these economically troubled times. While the abuses must be—and are being—stopped, rollups can play an useful role for investors and business. We believe that the existing authority of regulatory agencies and self regulatory organizations, which were established by Congress precisely and flexibly to address just these kinds of abuses, is appropriate to address rollup problems.

The NASD has adopted and filed with the Securities and Exchange Commission (SEC) a comprehensive set of rules that should eliminate the past abuses of rollup transactions and will assure their fairness in the future. These regulations were developed pursuant to the legislative initiatives taken in the 102nd Congress and the letter received from Chairman Dodd and 17 other Senators on October 8, 1992 expressing their support for the quick passage of our rules. Indeed, within six weeks of the letter my Direct Participation Program Committee and the Board of Governors of the NASD approved the rule changes that are currently on file. NASD regulations only apply to our members, however, and we would support legislation that would apply these protections also to those few rollups where an NASD member is not involved, and where the surviving entity does not list in our market.

Large nationwide rollups of partnerships are difficult to accomplish without the use of NASD members. However, smaller rollups with a limited number of partnerships can, and have, been solicited without NASD members and are not therefore covered by our rules. Moreover, this legislation will provide uniformity for listing of rollup securities on the major markets. Passage by Congress of legislation that mirrors our rules will assure a uniform standard for NASD members and non-members alike. While our rule proposal on file with the SEC—which we discuss in this testimony and applies only to our members—addresses the abusive practices that have occurred in the past, we believe legislation to provide equal regulation of non-NASD members and equal regulation of listing standards is appropriate.

I. The NASD

The NASD is registered with the SEC as a national securities association under the Securities Exchange Act of 1934 (the "Exchange Act"). The NASD is the only association so registered. It is a self regulatory organization (SRO) and an operator of electronic securities markets. As a market operator it runs the Nasdaq Stock Market, which is the second largest securities market in the world. As an SRO it is charged with the responsibility of regulating the over-the-counter securities markets.

The NASD has 5,200 broker-dealer members employing 460,000 registered sales persons and principals. The scope of the NASD's regulatory jurisdiction extends to all such members and their associated persons. While the 2,830 staff of the SEC and the roughly half that number of state securities regulatory staff must deal with all aspects of securities regulation, the 2,000 staff of the NASD focuses only on the regulation of its members and the operation of Nasdaq and the over the counter securities markets. Through close cooperation with Federal and state regulators, overlap and duplication is minimized, freeing governmental resources for securities regulation to be focused on other areas.

The NASD carries out its examination, disciplinary, and other regulatory responsibilities through its Washington headquarters and fourteen offices located in major cities throughout the country. In addition to District Business Conduct Committees consisting of industry volunteers that work with the regional offices, the NASD has a national Market Surveillance Committee, also made up of industry volunteers, that deals specifically with equity trading and market related issues. A committee of the NASD Board of Governors, the National Business Conduct Committee, reviews as an appellate body the disciplinary actions of the District Business Conduct Committees and the Market Surveillance Committee. This serves to assure fairness and, to the extent possible, uniformity in disciplinary actions. Final NASD disciplinary actions can be appealed to the SEC and then to the United States Courts of Appeals.

The NASD is governed by a twenty-nine member Board of Governors drawn from its membership, leaders of industry and academia, executives of Nasdaq companies, and the public. The Board, through a series of standing and select committees, monitors trends in the industry and promulgates rules, guidelines, and policies that it deems necessary to protect investors, issuers, and market intermediaries. One of these committees, the Direct Participation Programs Committee, of which I have been a member for the last five years and have chaired the last two years, is charged with the responsibility for oversight of the partnership industry in developing recommendations for rulemaking where appropriate.

II. Role of the NASD in Rollup Regulation

I believe that it is important to recount briefly the highlights of recent activity of the NASD in connection with abusive limited partnership rollups.

In the legislative area, the NASD has since 1990 given technical assistance to the Congress on rollup abuses. It has testified before the House and Senate a number of times on the three bills that were introduced in 1991—H.R. 1885, S. 1993, and S. 1423. We were also involved extensively in their drafting and revision, and have served as a resource to House and Senate staff in their formulation of legislation.

Before any of this legislation was introduced, however, we were aware of the problems with abusive rollups and had started the first of our several rule changes to address those problems. In December 1990 the NASD took action on differential compensation through its Direct Participation Programs Committee. In April 1991 I chaired a special Rollup Subcommittee of our Direct Participation Programs Committee consisting of experts representing limited partners, general partners and NASD members. The subcommittee developed the rule changes and regulatory improvements relating to Appendix F of our rules and Schedule D of the by-laws noted below.

- *Differential Compensation*—The first major regulatory action taken to deal with abusive rollups was the NASD rule to limit differential compensation in the solicitation of approvals for rollups. Differential compensation was the practice where a general partner would pay broker-dealers soliciting investor consents to the rollup for a yes vote but not for a no vote. Because this payment system created a potential conflict of interest for the broker-dealer by providing an incentive for the member to recommend approving the rollup, possibly contrary to the member's duty to advise in the investor's best interest, the NASD in December, 1990 proposed prohibiting this practice and setting a limit on compensation to be paid. We received 54 comment letters, with 89 percent of them supporting banning the practice. The NASD Board of Governors approved the rule in May 1991, and the SEC approved the rule change on August 19, 1991.

- *Listing Standard Changes*—The second major NASD rule proposal concerned the standards that must be met before a limited partnership can be listed on the Nasdaq/National Market System. The NASD approved in May 1991 a proposal for specific listing standards on, partnerships. That proposal was combined with finder regulations on abusive rollups and published as NASD Notice to Members 91–78, published December 1991, and discussed more fully below.
- *Study and Notice on Secondary Market for Limited Partnerships*—In November 1991 the NASD published Notice to Members 91–69, based on recommendations of the Direct Participation Programs Committee, which reported the results of a study of the secondary market for limited partnerships, and re-emphasized the applicability and relevance of NASD regulation in this market. Because the fragmented and inefficient secondary market is currently the only alternative for limited partners to sell their limited partnership units if they do not want to participate in the rollup, the NASD wanted to ensure that all members complied with all relevant rules and regulations. The study found numerous examples of unawareness of applicable rules, especially those involving markups, suitability of recommendations, and best execution, and provided guidance on compliance.
- *Limitations on NASD Member Participation in Unfair Rollups and Listing of Rollup Securities*—In December 1991 the NASD proposed comprehensive changes to its Appendix F under Article III, Section 34 of the Rules of Fair Practice and Schedule D to the NASD By Laws. Those amendments would have restricted member participation in unfair rollup transactions and prohibited listing on the Nasdaq/National Market System of any security resulting from an unfair rollup transaction. These changes were based on H.R. 1885, introduced by Chairman Markey and Congressmen Rinaldo and Dingell in April 1991. That bill would have placed a number of requirements for rulemaking on the NASD, and effectively would have prohibited all rollups until all required regulations were adopted. The NASD proposed rules prior to the passage of the legislation to foster the reforms in the bill and to minimize the lag time for NASD rules to be implemented. It received 42 comments, and its special Rollup Subcommittee met numerous times during 1992 to consider how rules should be proposed to the SEC based on those comments. In late 1992 the Senate passed S. 1423 covering rollups. Although Congress adjourned in October of 1992 without enacting rollup legislation, the NASD Board, at its November 1992 meeting, approved the rules in a form modified to respond to comments and to incorporate the major provisions of the Senate's rollup bill. Those proposed rules subsequently were filed with the SEC and are discussed more fully below. We are confident they will eliminate the abusive practices that gave rise to legislative and regulatory concerns over rollup transactions.
- *Clarification of SEC Proxy Rules for Broker Dealers*—As part of its efforts begun with its differential compensation rule—to ensure that limited partnership investors are provided with objective information on their proxy vote, the NASD asked the SEC to clarify that broker-dealers may rely on the safe harbor provision of SEC Rule 14a–2(b)(2) to contact a customer and advise them on a rollup transaction. The SEC's approval of that request was contained in Notice to Members 92–33, in June 1992, and furthers the ability of a broker dealer to give appropriate advice to its clients on rollup transactions.

In addition to these efforts of the Congress and the NASD, the SEC has made important strides in addressing rollup abuse. The SEC published interpretive guidance that focused on the need for clear, concise and comprehensible disclosure, as well as the need to highlight the potential adverse effects, and adopted rules requiring extensive additional disclosure bearing on the fairness of the transaction and risks to investors. These new requirements include: extensive new information on the procedural and substantive fairness of rollups and rollup sponsors conflicts of interest; extensive disclosure about any fairness opinions or other reports obtained by roll-up sponsors; disclosure of the risks of rollups for limited partners and the benefits for sponsors; individual prospectus supplements for investors in each partnership highlighting the risks and fairness of the rollup; a solicitation period of sixty days; and a right to shareholder or limited partner lists in the case of a rollup or going-private transaction.

III. NASD Proposed Rules

The NASD rules generally prohibit a member from participating in a rollup transaction unless the transaction complies with specified provisions intended to protect limited partners. Specifically, dissenting limited partners must be offered the right to receive compensation for their partnership units based on an independent appraisal of partnership assets, or the right to receive or retain a security with substantially the same terms and conditions as the security originally held. These

rights need not be offered if other comparable rights acceptable to the NASD are provided to dissenting limited partners.

Compensation Based on Appraisal: This provision, substantially the same as proposed in Notice to Member 91–78, would provide that dissenting limited partners may receive compensation based on an independent appraisal by an appraiser unaffiliated with the sponsor or general partner of the program, that values the assets as if sold in an orderly manner in a reasonable period of time, plus or minus other balance sheet items, and less the cost of sale or refinancing. These requirements should insure that the appraisal accurately reflects the current value of the assets. In response to members' comments to the version of the proposed rule change published in Notice to Members 91–78, an additional provision was added that would require that the appraisal be done in a manner that is consistent with appropriate industry practice.

Forms of compensation that may be provided based on the appraisal include cash, secured or unsecured debt instruments, and freely-tradable securities. All debt instruments (which must provide for a trustee and an indenture under Federal law) provide for prepayment with 80 percent of the net proceeds of any sale or refinancing of the assets of the entity.

In addition, all debt instruments must provide the holders with a rate of interest equal to at least 120 percent of the applicable Federal rate, have a term no greater than 8 years, and allow for the use of unsecured debt instruments only when the entity issuing the debt has a limitation on total leverage of 70 percent of the appraised value of its assets. These requirements impose significant restrictions on the ability of general partners or sponsors to offer debt instruments as compensation to dissenters, and the substantive requirements of this rule seek to reduce the risk to a dissenter of holding the debt instrument. By limiting the term of the debt to that of a medium term security, limiting the total leverage of the new partnership to 70 percent when issuing unleveraged debt and imposing an obligation to state a rate of interest it is believed that limited partners and their financial advisers will be better able to assess the viability of the debt instrument and the new entity's ability to meet its repayment obligations. Also, unlike junk bonds and other forms of creative corporate financing, the general partner is obligated to structure the debt so that 80 percent of the net proceeds of the sale or refinancing of properties owned by prior partnerships must be paid to dissenters. This priority return is intended to induce general partners to repay the debt as quickly as possible.

Receipt of a Security with Substantially the Same Terms and Conditions: The rules provide that dissenting limited partners may receive or retain a security with substantially the same terms and conditions as the original issue. The terms of such a security must entail no material adverse change as to the business plan or the investment, distribution and liquidation policies of the partnership and must ensure that dissenting limited partners receive or retain a security with substantially the same rights, preferences and priorities as their current security. This differs from the Senate bill, S. 424, which includes the same concept as an exclusion from the legislation, as discussed below.

Comparable Rights

The proposed rule permits other comparable rights to be given limited partners to provide flexibility for sponsors and general partners to propose other protections in lieu of appraisal and compensation or the ability to retain a security. (This is also different from S. 424, which calls for "other rights," as discussed below.) The comparable rights options include, but are not limited to, supermajority approval of the transaction and the right of review of the transaction by an independent committee. As noted below, the Senate bill's approach, which permits other rights without a finding of unfeasibility, has been included in the NASD rules in lieu of the House provision, which requires that before other rights are offered, the NASD find that it is infeasible to provide dissenters with the right of appraisal and compensation. We prefer the Senate bill's provision because it provides greater flexibility in addressing the needs of all the limited partners.

Supermajority Approval

The premise that underlies many of the objections to rollups is that a simple majority of limited partners voting for a rollup can deprive other limited partners of the business and financial opportunities they bargained for when they originally invested. However, this objection is overcome if limited partners owning 75 percent of the partnership interests take affirmative action to approve the rollup transaction. The NASD believes that such an overwhelming approval of the transaction, which is very difficult to get in most cases, should operate as an indication of the

fairness and beneficial nature of the rollup and would qualify as a "comparable right."

REVIEW BY INDEPENDENT COMMITTEE

The NASD also permits the use of an independent committee as a "comparable right." The NASD believes that one of the primary weaknesses of the position of limited partners in a rollup transaction is the fact that they have no substantive role in structuring the transaction. This lack of input permits general partners and sponsors to propose potentially unfair arrangements. An independent committee composed of limited partners and their representatives is a substantive method of injecting arm's length bargaining into the negotiation of the terms of the rollup. The members of the independent committee will be able to assert their interest in a fairer transaction before it becomes public in negotiations with the general partner. Moreover, the committee is obligated to issue a report stating its findings and conclusions for the benefit of the limited partners, and it is highly unlikely a rollup will be approved without the support of the independent committee.

The rules governing the structure and deliberation of the independent committee call for fair representation of the interests of limited partners, permit the independent committee to negotiate for the benefit of all partners, permit the independent committee to inspect the books and records of the partnership, and require that a report of the committee's deliberations be published. The independent committee also has the right to seek compensation and payment for its expenses from the parties involved in the rollup and permit indemnification to be negotiated from general partners. The NASD believes that the framework established by the rules will permit a general partner to seek input from affected parties to assure that the terms of the rollup are acceptable.

OTHER COMPARABLE RIGHTS

Comparable rights for dissenting limited partners are not limited to supermajority approval or the establishment of an independent committee, but include any other comparable right proposed by general partners or sponsors, provided that they demonstrate to the satisfaction of the NASD or, if the NASD determines appropriate, to the satisfaction of an independent committee, that the rights proposed are comparable. The NASD believes that the provision for other comparable rights is desirable to allow the marketplace to utilize its creativity to develop plans for the benefit of the partnership and procedures for the protection of dissenting limited partners without the rigid straitjacket of pre-ordained regulatory or legislative formulae.

The NASD rules also provide that a rollup transaction is presumed to be unfair and unreasonable if: (1) certain actions taken by the general partner result in the unfair conversion and valuation of general partner interests in a rollup; (2) a rollup fails to protect the voting rights of the limited partners; (3) the transaction costs of a rejected rollup are unfairly apportioned or allocated; and (4) the payment of fees to general partners in connection with rollup transactions is unfair, unreasonable or inappropriate. These are the areas that have caused the most concern with past rollups and closely follow the provisions contained in S. 424.

Actions Taken By the General Partner: The provision in the proposed rules for protection against actions taken by general partners provides that it is presumptively unfair and unreasonable for general partners, when determining their interest in the new entity resulting from a rollup, to: (1) convert an equity interest for which consideration has not been paid into a voting interest in the new entity where such equity interest was not otherwise provided in the limited partnership agreement and disclosed to limited partners; (2) fail to follow the valuation methods indicated in the partnership agreements when valuing their partnership interests; or (3) utilize a projected value of their equity interest rather than the appraised current value of their equity interest when determining their interest in the new entity.

Voting Rights: The NASD is proposing four provisions for the protection of investors on voting rights. The first presumes a proposed rollup is unfair if the voting rights in the entity resulting from the rollup do not follow the original voting rights of the limited partnerships participating in the rollup transaction. However, the NASD recognizes that certain material changes to voting rights may be necessary to conform disparate rights that may exist among participating partnerships, or to conform to a new corporate or trust structure. However, material changes may be effected only if the NASD determines that such changes are not unfair or if an independent committee approves such changes.

The second provision presumes a proposed rollup is unfair if a majority of the interests in an entity resulting from a rollup cannot take certain actions without concurrence by the sponsor, general partner(s), board of directors or trustee; such as a vote to amend the limited partnership agreement, articles of incorporation, by-

laws or indenture; dissolve the entity; remove and elect new management; and approve or disapprove the sale of substantially all the assets of the entity.

The third provision presumes a proposed rollup is unfair regarding voting rights if the sponsor or general partner is not required to provide a document which clearly delineates instructions and procedures of voting against or dissenting from a proposed rollup transaction.

Finally, the fourth provision presumes it unfair if the general partner or sponsor fails to utilize an independent third party to receive and tabulate all votes and dissents, and fails to require the third party to make the tabulation available to the general partner and any limited partner upon request at any time during and after voting occurs.

Transaction Costs: A provision in the proposed rules protects against a failure to fairly apportion or allocate transaction costs. On determining total costs for a rejected rollup transaction, the NASD believes that the rule clarifies that the general partner must pay all the solicitation expenses and, in addition, transaction costs in proportion to the total number of abstentions and votes to reject the transaction. Additionally, limited partnerships which dissent from, and are not included in, a rollup transaction which is ultimately consummated may not be assessed any transaction costs.

Fees of the General Partners: The provision in the proposed rule for protection against the unfair assessment of fees provides that it is presumptively unfair for general partners to receive or convert unearned management fees discounted to a present value while also proposing to receive new asset-based fees.

IV. S. 424, the Limited Partnership Rollup Reform Act of 1993 and Differences with NASD Proposed Rules

S. 424, which is substantially similar to S. 1423 from the 102d Congress, would require the SEC to amend its rules relating to the proxy process and disclosure. The legislation would also amend the Securities Exchange Act of 1934 by requiring registered securities associations such as the NASD to adopt rules prohibiting members from participating in a rollup and prohibiting the surviving entity from listing its securities on the NASDAQ National Market System or an exchange if specified protections are not afforded limited partners.

The NASD's proposed rules are based on the provisions of previous proposed legislation and seek to follow the areas of past rollup abuses that were delineated in those bills. The NASD rules do not differ greatly from the provisions of S. 424.

One difference relates to the "same security" concept that S. 424 incorporates as an exclusion from the definition of a rollup. If each investor is provided an option to receive or retain a security under substantially the same terms and conditions as the original security, the transaction is not a rollup under the bill. We support this exclusion from the definition of a rollup. NASD rules, which in this respect followed H.R. 1885, also permit the sponsor of the rollup to satisfy dissenting limited partners by offering them the right to retain a security under the same terms and conditions as their original security. We believe that the same security concept should also be available with respect to dissenters rights so that if the same security is not offered in the original rollup transaction it still can be utilized to satisfy dissenting limited partners. This would provide necessary flexibility to the sponsor of the rollup to satisfy dissenting limited partners. The concept in each case is identical, whether a same security is used for the entire class, in which case the rollup is an excluded from the bill, or just for dissenters, in which case it should be available as compensation to the limited partners.

Second, NASD rules excluded from the definition of a rollup the situation where an independent, non-affiliated third party proposes to take over the partnership from the existing general partner or sponsor with the conditions that the transaction must be approved by 66⅔ percent of the limited partners of each partnership, and the existing general partner(s) may not receive any compensation other than what they are entitled to under the pre-existing partnership agreement. The NASD feels that a transaction of this type, which is structured in many ways like a tender offer, does not contain the potential for abuse that the rules were designed to protect against. In this narrowly drafted exception, a third party tender must include a reorganization that is fair enough to induce two-thirds of the limited partners to tender their interests, or the offer fails. Therefore the NASD believes that the market will require a serious and fair tender offer or the rollup will not be consummated. It is important to note that the current sponsor or general partner cannot receive any payment from the third party as inducement to support the rollup.

Finally, the NASD rollup rules except from the rollup definition any reorganization of limited partnerships that by the terms of the pre-existing limited partnership agreement provide that the interests of the limited partners may be repurchased,

recalled, or exchanged for securities in an operating company specifically identified at the time of the formation of the original limited partnerships, and which securities are required to be registered under the 1933 Securities Act at the time of the restructuring. Such partnerships with a pre-existing agreement would include, for example, limited partnerships (1) established solely for the purpose of conducting research and development, and (2) which were always intended to be merged with a parent or other affiliate and are generally not available to the retail public. The NASD does not wish to impede partnership reorganizations that were generally agreed to at the time of the original decision to invest. Further, these are not the types of transactions where abuses have been reported.

The only other difference between S. 424 and the NASD regulations is not a difference at all and relates to the use of "other rights" in lieu of appraisal and compensation to limited partners. The NASD rules call for "other *comparable* rights," which can be considered a further definition of "other rights." Other comparable rights include approval by 75 percent of limited partners, an independent committee, and other comparable rights approved by the NASD or, if the NASD deems appropriate, by an independent committee.

V. Conclusion

The NASD believes that its proposed rules, if approved by the SEC, will appropriately regulate activities in connection with rollups and protect limited partners from the abuses that have occurred in the past in connection with rollup transactions. The rules are patterned after the principles set forth in the Senate bill and are consistent with the protections that bill sought to provide.

NASD regulations apply only to our members, however, and we would support legislation that would apply these protections also to those few rollups where an NASD member is not involved, and where the surviving entity does not list in our market. Large nationwide rollups of partnerships are difficult to accomplish without the use of NASD members. However, smaller rollups with a limited number of partnerships can, and have, been solicited without NASD members and are not therefore covered by our rules. Moreover, this legislation will provide uniformity for listing of rollup securities on the major markets. Passage by Congress of legislation that mirrors our rules will assure a uniform standard for NASD members and nonmembers alike. While our rule proposal on file with the SEC—which applies only to our members—addresses the abusive practices that have occurred in the past, we believe legislation to provide equal regulation of non-NASD members and equal regulation of listing standards is appropriate.

Thank you for the opportunity to testify on the NASD's views on limited partnership rollup regulation and legislation. I would be pleased to answer any questions you may have.

STATEMENT OF BARRY GUTHARY

PRESIDENT, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

EXECUTIVE SUMMARY

The abuses and resulting financial losses suffered by limited partners caught in limited partnership roll-ups are well known to this Subcommittee. It has been estimated that since 1990 more than 500,000 small investors have been adversely affected by roll-ups and that as many as eight million small investors potentially are at risk. According to the SEC, from January 1, 1985 to February 15, 1993, 74 rollup transactions involving two or more partnerships have been registered with the Commission. These roll-ups have involved approximately 1,800 limited partnerships valued at approximately $7.3 billion. The concern today is that the passage of time has done nothing to stem the tide of abusive roll-ups.

In this new year and new congressional session, it is clear that roll-ups continue to pose a serious threat to the millions of small investors who placed their funds in limited partnerships. There is no evidence that any actions taken to date will dramatically alter the roll-up process so that limited partners get a fair shake. No matter how well intentioned and laudable these efforts may be, they represent incremental steps, not the giant leaps necessary to solve the underlying cause of the roll-up problem. In looking at the abuses associated with roll-ups it quickly becomes obvious that the reforms put in place amount only to what may be considered "tinkering at the margins," when what is needed is a direct approach to the substantive core issues. The only prospect for truly comprehensive, meaningful and effective reform of the roll-up process is Federal legislation.

Mr. Chairman and Members of the Subcommittee, NASAA is pleased to lend its support for the important reforms contained in S. 424, the "Limited Partnership

Rollup Reform Act of 1993." If adopted, these reforms will go a long way toward remedying the pervasive investor abuses now present in the roll-up process and will help restore the eroded investor confidence in these markets. In addition to supporting the reforms contained in S. 424, NASAA respectfully requests that, at the appropriate time, the Senate consider adding to its legislation the following provisions:

- Limitations on the use of "other comparable rights" in lieu of appraisal and compensation to dissenting limited partners to those instances in which it is determined to be "infeasible or not in the financial interest of the dissenting limited partners . . .";
- Mandatory independent fairness opinions;
- A moratorium on roll-up transactions between the date of enactment and the implementation of SEC rules and regulations thereunder; and
- Clarification that the Act's exclusion for certain securities not required to be registered under the Securities Act of 1933 does not extend to the Act's mandated disclosure and independent fairness opinions.

Finally, NASAA wishes to take this opportunity to commend the Chairman of this Subcommittee and other Members, as well as your hardworking staffs, for your unwavering commitment to protecting the rights and interests of small investors.

Mr. Chairman and Members of the Subcommittee: Good morning. My name is Barry Guthary. I am director of the Massachusetts Secretary of State's division of securities and president of the North American Securities Administrators Association (NASAA). In the U.S., NASAA is the national voice of the 50 state securities agencies responsible for investor protection and the efficient and fair functioning of the capital markets at the grassroots level. On behalf of NASAA, appreciate the opportunity to appear before you today to testify in support of S. 424, the "Limited Partnership Rollup Reform Act of 1993."

Before getting into the specifics of NASAA's support for the pending legislation, I would like to take this opportunity to commend you, Mr. Chairman, and other Members of this Subcommittee, for your unwavering commitment to protecting the rights and interests of small investors. In testimony before this Subcommittee on February 27, 1991, my colleague, Arizona Securities Division Director Dee Harris, recognized that it was the extensive review conducted by you and your staffs which resulted in the broad exposure of the extremely serious investor protection issues that arise in connection with limited partnership roll-ups.[1] Regrettably, and despite your considerable efforts to the contrary, limited partners today have little in the way of meaningful protections against abusive roll-up transactions.

THE THREAT OF ROLL-UPS TO SMALL INVESTORS

Mr. Chairman, the abuses and resulting financial losses suffered by limited partners caught in roll-ups are well known to this Subcommittee. Reports of roll-up abuses are widespread and also have attracted calls for reform at the state-level, at the Securities and Exchange Commission (SEC) and at the National Association of Securities Dealers (NASD). It has been estimated that, since 1990 more than 500,000 small investors have been adversely affected by roll-ups and that as many as eight million small investors potentially are at risk. According to the SEC, from January 1, 1985 to February 15, 1993, 74 rollup transactions involving two or more partnerships have been registered with the Commission. These roll-ups have involved approximately 1,800 limited partnerships valued at approximately $7.3 billion.[2] The concern today is that the passage of time has done nothing to stem the tide of abusive roll-ups.

Last year, the chairman of the House Telecommunications and Finance Subcommittee released data compiled by the staff of the Securities and Exchange Commission which demonstrated that the roll-up phenomenon at that time was far from over, despite the intense scrutiny of the Congress, state and Federal regulatory

[1] Simply stated, roll-ups refer to the process whereby one or more limited partnership(s) are reorganized into a new security that is exchange-listed.

[2] *See* House Report 103-21, "Limited Partnership Rollup Reform Act of 1933," to accompany H.R. 617, February 25, 1993, page 7; Kirstin Downey Grimsley, "Limited Partnership 'Roll-ups' Are Targeted," *Washington Post*, February 13, 1993, p. E1; and prepared statement of John Freeman Blake, chairman, American Association of Limited Partners, for a hearing before the Committee on Finance, Subcommittee on Energy and Agricultural Taxation, U.S. Senate, concerning S. 1393, "Taxation of Limited Partnership Rollups," July 16, 1991. S. Hrg. 102-273, p. 39.

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agencies and the news media. According to the SEC's analysis,[3] 20 limited partnership roll-up transactions took place in 1991, affecting approximately 300,000 investors in 132 partnerships. How did investors fare in those deals? Limited partners watched helplessly as their holdings dropped by an average of nearly 50 percent from the exchange value assigned by roll-up sponsors prior to the transaction.

What can we expect during 1993? In its submission last year to the Subcommittee, the SEC also reported that an additional eight rollups were awaiting completion, affecting 18 limited partnerships and nearly 170,000 investors. In October of last year, a managing director of Dean Witter Reynolds and a leading investment banker for roll-up transactions, declared at a partnership industry meeting that "the [roll-up] market is back in action."[4] While he did not name names, this industry executive indicated that he knew of "six pending roll-ups valued at at least $100 million each, with three of those probably exceeding $500 million."[5]

Finally, consider a more recent situation: Investors in 35 oil and gas limited partnerships sponsored by Prudential Securities and Graham Royalty were faced with deciding whether to accept a proposed settlement of several class action lawsuits which would have involved a roll-up of the partnerships. The 35 partnerships involved in the settlement were formed from 1983 to 1990 with $1.445 billion in limited partner contributions. In total, the partnerships have some 128,000 investors.[6] If it were agreed to, the reorganization would have converted the settling investors' interests in the 35 finite-life partnerships currently paying distributions into shares in an infinite-life corporation intending to pay little, if any, dividends. To "assist" them in making their decision, investors were given a nearly 300-page document explaining the settlement and proposed roll-up terms! (The bulk of the 300 pages was devoted to the roll-up proposal.) Brokers for the firm were barred from advising their clients about the proposed settlement deal. No fairness opinion accompanied the roll-up prospectus.[7]

In what many considered to be a surprise ruling, U.S. District Judge Marcel Livaudais Jr., before whom the proposed roll-up and settlement was pending, said on February 19, 1993, that he was indefinitely postponing a ruling on the fairness of the settlement, citing a desire for more information from state securities agencies conducting investigations and from others involved in the case.[8] On the heels of this statement by Judge Livaudais, a tender offer for approximately $173 million was made by GBK to buy out a substantial portion of the partnerships involved here. This unexpected tender offer, with terms well below the $700 million value of the underlying partnerships' assets, forced the general partners to abandon their pending roll-up proposal and instead, they now are focusing on trying to arrange a sale of the partnerships' assets.

In an advertisement in the April 16th edition of the *Wall Street Journal,* the general partners notified the limited partners that they have a number of potential purchasers for the partnerships' properties and that they believe that a competitive sale process would result in the limited partners "receiving a substantially higher price than [that] offered" in the pending GBK tender offer. As a result, the general partners urged limited partners to "reject the GBK tender offer" and recommended that limited partners "not tender your units." The advertisement closed by saying, "We hope to conclude the sale process, intended to maximize the value of your units and prevent GBK from depriving you of that value, as soon as practicable."

This last statement by the general partners begs the question, "why was the roll-up proposed in the first place?" When over half a billion dollars in very liquid assets could have been sold for the benefit of the limited partners, why did the general partners pursue a course which would have transferred those assets to their control? Clearly, our regulatory system needs reform to prevent roll-ups of this abusive type from being offered in the future. And, while NASAA is enthusiastically supporting S. 424, we also are suggesting additional reforms to include in this package. The

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[3] Staff of the Division of Corporation Finance, Securities and Exchange Commission, "Supplemental Report: Information Concerning Roll-ups Requested in December 18, 1991 letter from Chairman Edward J. Markey, January 10, 1992. See also, News Release of Rep. Edward Markey, "Rollups Losses Continue, According to SEC Data," February 3, 1992.

[4] Karen Slater D'Amato, "Partnership 'Roll-Ups' Revived As California Enacts New Rules," *Wall Street Journal,* October 29, 1992, p. C1.

[5] D'Amato, p. C1.

[6] Spencer Jefferies, "Prudential Makes Settlement-Rollup Offer," *The Perspective,* November/December 1992, p. 1.

[7] Barry Vinocur, "In or Out? That's What Investors in a Pru-Bache Deal Must Decide," *Barron's,* January 18, 1993, p. 14.

[8] *See,* United States District Court, Eastern District of Louisiana, *In Re: Prudential-Bache Energy Income Partnerships Securities Litigation,* February 19, 1993. Also, Scot J. Paltrow, "Judge Stalls Prudential Settlement," *Los Angeles Times,* February 22, 1993, p. B5.

proposed Prudential/Graham roll-up is a glaring example of why the current system and recent initiatives of the SEC, NASD and others are deficient and why comprehensive Federal legislation, such as S. 424 is necessary. Under those initiatives, this example of an abusive roll-up never would have been stopped.

Mr. Chairman and Members of the Subcommittee, in this new year and this new congressional session, it is clear that roll-ups continue to pose a serious threat to the millions of small investors who placed their funds in limited partnerships. There is no evidence that any actions taken to date will dramatically alter the roll-up process so that limited partners get a fair shake. No matter how well-intentioned and laudable these efforts may be, they represent incremental steps, not the giant leaps necessary to solve the underlying cause of the roll-up problem. The only prospect for truly comprehensive, meaningful and effective reform of the roll-up process is Federal legislation.

REGULATION OF LIMITED PARTNERSHIPS AND ROLL-UPS

Mr. Chairman, as this Subcommittee is well aware, overseeing the multi-trillion dollar investment marketplace in the United States is an enormous task that directly affects the financial well-being of millions of Americans and requires the close attention of the Federal and 50 state governments. While the Securities and Exchange Commission rightfully commits its resources to broad, market-wide regulatory activities, state securities agencies devote the bulk of their efforts to those regulatory and enforcement issues which most directly affect small investors.

State Regulation of Limited Partnerships

Limited partnerships are among the riskiest and most illiquid of all instruments in the investment marketplace.[9] In addition to the absence of an active trading market, limited partnerships are distinguished by the fact that they are almost exclusively designed for, and sold to, small investors, many of whom have relatively limited financial sophistication. Since the protection of such individuals from fraud and abuse is the primary focus of state securities regulation, NASAA has adopted a comprehensive set of registration guidelines for newly-created limited partnerships involving real estate, oil and gas, equipment leasing, cattle feeding, and commodity pool programs. These Guidelines are used widely by the sponsors of limited partnerships as they structure their deals and also form the basis for state securities agency review of partnership registration filings.

While the Guidelines are custom-tailored to reflect the unique nature of each type of partnership, they do share substantive provisions intended to guide the conduct of program sponsors. For broker dealers, the NASAA Guidelines set out customer suitability standards and limits on overall organization and offering expenses. (Each NASAA Guideline contains specific minimum suitability criteria which a potential investor must meet before purchasing an interest in a limited partnership.) The Guidelines have been revisited and updated periodically in response to changing market and economic considerations. For example, in a real estate limited partnership, the following elements of "Limited Partner Rights and Protection Provisions" would come into play:

- **Limited partners' voting rights.** Specific limited partner voting rights must be observed, including those related to partnership dissolution, amendment of the partnership agreements, sale of substantially all assets and general partner removal. These rights may be exercised by a simple majority vote of the limited partners. Also addressed is the right to call special meetings, demand a vote and obtain lists of names and addresses of all limited partners.
- **Suitability.** Specific standards for customers are enumerated in the Guidelines, with variations accounted for in the differences in the programs and markets.
- **Minimizing the potential for conflicts of interest.** In order to prevent self-dealing on the part of the general partners, compensation standards have been developed in the event that the general partners provide goods and services to the partnership.
- **Prohibition on the commingling of partnership funds.** Although such practices are prohibited, a sponsor may establish a master account for the benefit of

[9] In a syndicated limited partnership, investors turn over their funds to a general partner (or sponsor) who is to manage the partnership's business. Limited partners do not participate in the management and the operation of the partnership's business, nor do they assume any liability, except, of course, for the capital they have contributed to the enterprise. The investments are for a specified duratiбn, after which the partnership's assets will be sold and the partnership dissolved.

various affiliated partnerships provided that the funds of one partnership are protected from the claims on the other partnerships.

- **Clear fiduciary duty.** The general partners have a fiduciary responsibility for the safekeeping and use of all funds and assets of the partnership and are prohibited from using such funds or assets in any manner except for the exclusive benefit of the partnership.
- **Financial statements and periodic reports.** Investors must be provided with audited financial information of the partnership and other periodic and annual reports. Also mandated are periodic financial disclosures relating to self-dealing and transactions with affiliates.
- **Sponsor's net worth, experience and financial statements.** Thresholds related to the sponsor's net worth and experience must be satisfied. Financial statements included in offering materials must conform to specific standards.
- **Termination of the general partner. Allows limited partners the right to remove the general partner upon majority vote and sets out provisions related thereto. Any termination of the general partner must be done on terms reasonable to the partnership.**

The Regulation of Roll-ups

While most state statutes provide for the registration of securities to be "offered" or "sold" to the residents of that jurisdiction, several exemptions from these registration requirements have been put in place. Most notable among the state registration exemptions is that which is provided for "any security listed or approved for listing upon notice of issuance" on the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), and in most states, certain regional exchanges and the National Market System (NMS) of the National Association of Securities Dealers Automated Quotation (NASDAQ) system.

The "exchange exemption," which dates back roughly 70 years in state securities statutes, is a recognition that certain securities required to meet the qualitative and quantitative standards of the exchanges do not require the additional oversight of state securities regulation. The widespread adoption of exchange exemptions reflected a responsible effort on the part of state securities regulators to relieve such securities in the national marketplace of state registration requirements. In more recent years, state securities regulators have moved to statutory recognition of the NASDAQ/National Market System (NMS) as the functional equivalent of a qualified stock exchange for the purposes of the registration exemption.

Until the 1980s, the nearly singular effect of the exchange exemption was to remove from the purview of state securities regulation the trading of listed common stock and bonds of nationally known companies. The states' exemptions for exchange listed securities were predicated on the existence and application by the exchanges of published listing criteria. However, recent years have seen the exchanges list certain initial public offerings (IPOs) and roll-ups that were not contemplated when the states originally adopted exchange exemptions. It is unclear to NASAA members exactly what standards are being used today by the exchanges to qualify roll-ups for listing.

Today, almost all roll-ups of public limited partnerships are exchange-listed or approved for exchange listing and, therefore, such offerings sidestep substantive review by the states. The net effect of this process is that individual limited partnerships that had been screened through state investor protection standards are converted literally overnight into investment instruments outside of the ambit of state regulation. In this way, limited partners are effectively stripped of the many and important safeguards required under the NASAA Guidelines.

While roll-ups are subject to Federal oversight by the SEC, the Commission is not currently authorized to employ in its regulation the substantive approach used by the states to regulate the initial limited partnerships. Under Federal securities laws, there must simply be full disclosure of the factors relevant to the investment in the public limited partnerships. The Commission neither imposes suitability standards for particular investments by customers; nor does it prohibit conflicts of interest by insiders or limit the amounts of commissions and compensation payable to the various parties of a partnership transaction. Perhaps most importantly, SEC rules do not prevent the roll-up sponsors from entrenching themselves in almost absolute control of the new entity. In the end, the safeguards used to protect limited partners at the state level are erased in the roll-up process and are not in any way compensated for by the current minimal Federal regulation of roll-ups.

NEW DEVELOPMENTS IN THE OVERSIGHT OF ROLL-UPS

Mr. Chairman, NASAA supports adoption of S. 424, notwithstanding the fact that the National Association of Securities Dealers, the Securities and Exchange Commission, the state of California, and indeed, NASAA itself, all have taken limited steps intended to curb roll-up abuses. While these efforts certainly are laudatory, it is NASAA's view that, absent the adoption of comprehensive Federal legislation applied evenly to all marketplace participants, we will fall short of meeting the needs of limited partners. The following discussion examines the various measures put in place and explains why these developments do not obviate the need for Federal legislation.

NASD

NASAA would like to take this opportunity to salute the NASD for moving forward with its roll-up rule proposals despite the absence of a Federal directive to do the same. The NASD's willingness to act here demonstrates its commitment to enhancing investor protections in this area and to improving investor confidence in this marketplace. However, it should be recognized that the NASD's action does not alleviate the need for Federal legislation, nor does it render such legislative action duplicative. Consider the following:

- *The necessarily limited reach of the NASD rules may encourage general partners to avoid this marketplace.* The NASD's rules will apply only to transactions involving its members and securities listed on the NASDAQ system. Roll-ups listed on other exchanges and transactions which do not involve NASD members will not be covered by the rules. Prior to the release of these rules there were examples of roll-ups which neither used NASD members nor listed on the NASDAQ. As a result, these transactions would fall outside of the scope of the NASD rules. If the NASD stands alone in its action, the likely result will be that roll-up sponsors simply will seek out alteratives for exchange listing and proxy solicitation so that they will not be subject to the rules of the NASD. Simply put, if Congress defers to the NASD here and does not adopt comprehensive Federal standards, the unfortunate effect may well be to erode what minimal protections now are in place as roll-up sponsors seek out the "path of least resistance." Such a scenario speaks volumes about why it is that we need a comprehensive Federal solution applied evenly to all marketplace participants.
- *The NASD's rules contain significant loopholes.* While the NASD is to be commended for moving forward with its proposal, it is NASAA's view that the final version of these rules is both weaker than the NASD's original proposal and weaker than the House version of the Federal legislation. NASAA generally is concerned that the rules:

  Do not in any way restrict the use of "other comparable rights" substitute for providing appraisal and compensation to dissenting limited partners. (Similarly, S. 424 does not restrict the use of "other comparable rights." NASAA's concern with this will be discussed in detail below.)

  Do not require an independent fairness opinion. As in the case with "other comparable rights," the NASD rules are similar to the Senate bill. Below is a discussion as to why NASAA believes this is in an important requirement which should be incorporated in the reform measure.

  Create an opportunity for certain "independent" third parties to carry out a roll-up without having to meet the same standard of conduct as that required of a general partner. This is accomplished through an exclusion to the definition of limited partnership roll-up which, under certain circumstances, would allow a roll-up transaction proposed by an independent, non-affiliated third party who would succeed the general partner to go forward without being required to meet the minimum investor protection standards set out in the rules. This language may create a significant opportunity for the continuation of abusive roll-ups. Several roll-ups, including the infamous Hallwood transactions, involved an ostensibly independent party taking over the management of programs they did not originally sponsor. There were no signs that limited partners were treated any more fairly just because the roll-up transactions were sponsored by parties independent of the original investment program.

Securities and Exchange Commission

The Securities and Exchange Commission has acknowledged the abuses associated with roll-ups and, as a result, has amended in certain respects its rules and regulations governing the same. Perhaps most significantly, the SEC in October 1991, adopted rule changes designed to make it easier for investors to comprehend the complex language of roll-up documents and to give investors adequate time in

which to consider the proposal. The benefit of these rule changes are significant and should prove useful to investors facing a roll-up, as should the proxy reforms more recently adopted by the Commission.

However, these rule changes are procedural only and do not provide up-front substantive protections for limited partners. It has been NASAA's experience in the limited partnership area that there simply is no substitute for putting in place minimum standards to guide the structuring of roll-up deals so that they are fair to investors. NASAA understands that the Commission is acting within what it believes to be its current authority to remedy the abuses associated with limited partnership roll-ups. It should be recognized however, that in areas heavily populated by small investors, such as is the case with mutual funds, Congress has seen fit to give the Commission enhanced authority to put substantive investor safeguards in place. NASAA respectfully suggests that limited partnership roll-ups would fall into the same category.

California

Effective January 1, 1993, roll-up transactions involving California limited partners will have to meet specific investor protection standards set out in the California Corporation Code or submit their proposed transaction for review and approval by the California Department of Corporations. In effect, this measure, approved by the Legislature in August 1992 and signed into law shortly thereafter, limits the availability of the state's current qualification exemption for securities listed or approved for listing on a national securities exchange as it applies to limited partnership roll-up transactions.

Proposed roll-up transactions which do not meet the standards articulated in the legislation will have to submit the proposal for review by the state securities agency, which has the authority to allow or deny the roll-up based on the guidelines set forth in the legislation. California's law is grounded in the belief that limited partners must have a meaningful choice when faced with a proposed roll-up transaction. As a result, the centerpiece of the legislation is found in the rights granted to dissenting limited partners.

While this action represents a significant step forward for California's limited partners who may face a roll-up, it does not diminish the need for a comprehensive, nationwide solution to the roll-up problem. The ambit of state securities regulation is necessarily limited and cannot address the range of issues now under discussion in the proposed Federal legislation. For example, there is no mandated independent fairness opinion under the new California rules, proxy rules are left unchanged, and the need for improved disclosure is not addressed. It is within the purview of Federal legislation *only* that these issues may be considered and resolved. A Federal statute in this area would work in tandem with the California law to provide the necessary investor protections for limited partners facing a proposed roll-up transaction.

NASAA

In October 1991, the NASAA membership approved amendments to existing Guidelines which govern the state-level registration of limited partnerships. These amendments were adopted in order to address *future* abuses in limited partnership roll-ups. Under the new NASAA Guideline language, newly-created limited partnership programs will not be permitted to enter into roll-ups without providing specific protections for investors, including dissenters' rights and access to needed information, such as the list of other limited partners.

However, it should be emphasized that the new NASAA Guidelines are strictly *prospective* in nature, and as such, will only come into play with the state registration of **new** limited partnership offerings. ***Existing partnerships that already have undergone state review will not be affected.*** (As discussed above, roll-ups of previously-registered partnerships are beyond the reach of NASAA members, since exchange-listed securities are exempt from review in almost all states.) In adopting the amendments, the Association cautioned that the new roll-up provisions in the Guidelines should in no way impede Capitol Hill consideration of roll-up reform legislation.

THE NEED FOR FEDERAL LEGISLATION

It is evident that existing Federal securities laws and regulations are unsuited to, and insufficient in the face of, the unique circumstances of roll-up contests. The current roll-up regulatory process was framed with traditional corporate restructurings in mind, where such factors as pre-existing securities, independent boards representing shareholders, the presence of institutional investors and the presumed existence of an efficient market work to maintain a level-playing field between all par-

ties involved. Clearly, limited partners facing a roll-up enjoy the benefit of no such circumstances. Therefore, it is both appropriate and essential that Congress direct the SEC to make the necessary adjustments to the Federal rules and regulations governing the process.

Mr. Chairman and Members of the Subcommittee, NASAA enthusiastically supports the roll-up reform legislation now under consideration, which is identical to the measure which last year received overwhelming and bipartisan support in this chamber. If adopted, the reforms contained in S. 424, the "Limited Partnership Roll-up Reform Act of 1993," will go a long way toward remedying the pervasive investor abuses now present in the roll-up process and will help restore the eroded investor confidence in these markets. In addition, NASAA encourages the Senate to consider adding to its legislation mandatory independent fairness opinions and limits on the use of "other comparable rights" in the place of appraisal and compensation for dissenting limited partners. Comments on specific elements of the proposed legislation follow.

Restoration of Investor Rights and Protections

Measures included in Section 3 of "The Limited Partnership Rollup Reform Act of 1993" would compensate for the loss of state safeguards for limited partners and would strengthen the SEC's ability to protect the interests of small investors in the roll-up process. Therefore, NASAA generally supports the elements of Section 3 of the proposed legislation which set out clear criteria as to the roll-up transactions in which members of the NASD may participate and those transactions which would qualify for listing on a national exchange or the NASDAQ system. In addition, and at the appropriate time, NASAA would encourage you to support measures to further enhance the investor protections contained in this section. The rights of limited partners faced with a roll-up proposal would be protected through the following reforms:

- **Dissenters' rights.** It is NASAA's view that limited partners opposed to a roll-up should be afforded a reasonable opportunity to preserve or liquidate their original investment. While we agree with the concept embodied in S. 424 that general partners should be given maximum flexibility so that alternative and *comparable* rights may be offered in certain instances, it is NASAA's position that limitations on the use of comparable rights should be put in place so that they are the "exception" and not the "rule." Specifically, it is NASAA's position that comparable rights should be reserved only for those situations in which the exchange or NASD finds that granting dissenters' rights would be *"infeasible or not in the financial interest of the dissenting limited partners . . ."* By contrast, S. 424 Would allow general partners to provide dissenting limited partners *"other rights designed to protect dissenting limited partners,"* no matter what the circumstances and without limitation. In other words, there would be no regulatory oversight as to when "comparable rights" would be deemed appropriate and fair. The result may be a serious dilution of a much needed protection for dissenting limited partners. NASAA believes that there should be a presumption in favor of financial alternatives for dissenting limited partners and that general partners seeking to use comparable rights should be required to submit to the exchange or NASD clear and convincing evidence that it would be infeasible or not in the financial interest of the dissenting limited partners to provide such financial alternatives.
- **Prohibitions on "supermajority" voting requirements.** It is a normal practice for state securities agencies to forbid supermajority provisions in the structuring of limited partnership offerings. However, these voting rights commonly are stripped away in a roll-up and replaced in the rolled-up entity with the imposition of "supermajority" voting requirements which require a greater than majority vote for limited partners to effect changes. Such a practice severely restricts the ability of limited partners to have a voice in the new entity and should be prohibited.
- **Restrictions on fees and compensation to general partners sponsoring the roll-up.** Strict limits are placed by state regulators on the self-enriching compensation and fees available to general partners and others involved in a limited partnership offering. Once the same limited partnerships are rolled-up, the general partners currently are free of any such restrictions and, as a result, have sought to enrich themselves with multi-million dollar packages of additional compensation, fees, and equity stakes not contemplated under the original partnership. These and other such "sweeteners" come at the direct expense of the limited

partners.[10] Therefore, NASAA supports the provisions of Section 3 which would place restrictions on the conversion of management profit-sharing interests and incentive fees into asset-based management fees. NASAA likewise supports the provision that would free limited partners from bearing the costs of a rejected roll-up proposal.

Proxy Solicitation Rules

While the reforms contemplated under Section 3 of the proposed legislation are indeed critical to the safeguarding of investor rights, the benefits of these measures would be significantly strengthened if the proxy solicitation process also is overhauled in order to restore a balance in the roll-up process between the relative powers of the general partners and the limited partners. The one-sided environment in which roll-up contests are conducted may be described as the antithesis of an "efficient market." In the absence of understandable and meaningful disclosure, sufficient review periods, permissible communication among limited partners, independent fairness opinions, and unbiased broker advice, limited partners will continue to be overwhelmed by the high-pressure tactics of roll-up sponsors and their associates, all of whom now work in concert to get the limited partners to vote "yes" on a roll-up proposal, no matter how bad a deal it may be for the investors. *NASAA recognizes that steps taken by the SEC and the NASD have addressed some of these issues. However, we continue to support comprehensive Federal legislation and believe it is appropriate to retain these statutory provisions.*

Therefore, NASAA supports the proxy solicitation reforms found in Section 2 of the proposed legislation, including:

- **More meaningful and understandable disclosure.** Since the promoters of a roll-up proxy contest are asking limited partners to "turn inside out" the nature of their original security, investment objectives and their prospects for profit, it is only reasonable that roll-ups should be held to the highest-possible, *clearest* and *most understandable* standards of disclosure. The misleading of limited partners that has occurred through the use of overly optimistic general partners' letters, fairness opinions based on incomplete data, voluminous proxies filled with highly complex and boilerplate legalese, the high-pressure methods of proxy solicitation firms and "yes" vote compensation for brokers, renders all but meaningless the disclosure currently provided in roll-ups. NASAA strongly supports the goal of more simple, readable and understandable disclosure and the inclusion of summary information in the roll-up prospectus. However, it must also be recognized that improved disclosure, in and of itself, will not cure the roll-up abuses.
- **Investor consideration of the roll-up proxy.** Limits on the permissible communications among shareholders were intended to apply to traditional corporate restructurings where opposing proxies may surface and clearly should not be applied in the case of limited partners who want to communicate among themselves about a roll-up proposal put forward by the general partners. These proxy rules have been aggressively used by general partners to frustrate the efforts of limited partners opposing roll-ups and should be changed.

  NASAA also supports the imposition of a requirement compelling general partners to provide limited partners with the list of all limited partners and general partners involved in the proposed transaction. The stalling and other tactics that have been used by general partners to withhold these lists from limited partners emerged as a major abuse in the roll-up process.

Finally, it is imperative that limited partners have adequate time in which to consider the roll-up prospectus and to make an informed decision as to their position on such a transaction. These decisions should not have to be made in a rushed or harried fashion; adequate time should be provided so that investors faced with "turning inside out" the nature of their original investment may make careful and informed decisions and have time to communicate among themselves as to whether limited partners will benefit from the deal. Therefore, NASAA supports a minimum 60 day timeframe in which investors may consider the roll-up prospectus.

- **Compensation for solicitation services.** Restrictions should be placed on compensation provided by the general partners for the solicitation of "yes" votes. While proxy solicitation firms may have impressive-sounding Wall Street addresses and appear to be legitimate and above-board operations, the high-pressure tactics used by some firms to strong-arm investors into voting "yes" on a roll-up proposal closely resemble the activities of the "boiler-room" operators we see peddling phony investments to the public. These practices most certainly are abusive to

[10] Many commentators have ascribed to these "sweeteners" a pivotal role in the precipitous first-day and long-term decline in roll-up trading values

limited partners and should be curbed. We are hopeful that the prohibitions imposed on general partners from providing differential compensation for the solicitation of "yes" votes will help remedy this problem. Differential broker compensation for "yes" votes also is of concern here. Investors seeking the advice of their broker on a proposed roll-up expect that advice to be unbiased and not tied to a financial incentive for soliciting "yes" votes. NASAA commends the NASD for its efforts to correct this problem and any future problems by prohibiting NASD members from receiving differential compensation in soliciting consents to roll-up transactions.

In addition, NASAA would encourage you to consider three additional issues:

- **Mandatory independent fairness opinions.** Rather than mandating independent fairness opinions, S. 424 simply would require disclosure of certain information related to the fairness opinion, if one is issued. NASAA believes that a critical element of roll-up reform involves both mandatory and independent fairness opinions. There is a tremendous potential for abuse when the compensation provided to the preparer of a fairness opinion is tied to the successful completion of the roll-up and when that opinion is based only on the data and other information provided by the general partner. In order to introduce some measure of accuracy and truthfulness into these opinions, standards for independence should be established. Opinions should be prepared by a truly independent party who does not have a financial stake in the outcome of the deal and who has undertaken an independent analysis of the fairness of the deal to limited partners based upon a review of the books, records, etc. of the sponsors of the roll-up. NASAA respectfully suggests that the Commission, in prescribing rules establishing the standards of "independence," consider not only the compensation provided for successful completion of the proposed deal, but also the past and future business relationships of the general partner and the fairness opinion providers.
- **A moratorium on roll-up transactions during the time between enactment of the bill and the promulgation of the SEC rules thereunder.** NASAA's concern here is that, absent a moratorium, as contained in the House bill, some general partners may be enticed to move forward before the "window closes." Concerns that roll-up deals now pending or proposed during the 18 months which may meet the standards of the bill would be adversely affected by such a moratorium, should be alleviated by the fact that the SEC could use the exemptive authority granted under the bill to allow such transactions to go forward during this time period.
- **Language clarifying the intent of the exclusion for transactions not required to be registered under the Securities Act of 1933.** Under the bill, there is an exclusion for transactions in which the securities to be issued or exchanged are not required to be registered under the Securities Act of 1933. It is NASAA's understanding that these transactions have been excluded because they involve securities issued in conjunction with bankruptcy proceedings or court-ordered reorganizations. In its report, the House Energy and Commerce Committee clarified its intent with respect to this exclusion.[11] Given the recent experience of the roll-up proposed in settlement of the Prudential class action suit, NASAA respectfully suggests that a provision be added to the final legislation clarifying that this exclusion does not extend to disclosure or fairness opinion requirements. As a result, investors who find themselves similarly situated to those in the Prudential case may have the benefit of meaningful and understandable disclosure and an independent fairness opinion.

CONCLUSION

Mr. Chairman and Members of the Subcommittee, the reforms contemplated under S. 424, the "Limited Partnership Rollup Reform Act of 1993," will go a long way toward restoring integrity to, and investor confidence in, the limited partnership marketplace. The extensive review conducted by this Subcommittee of limited partnership roll-ups has provided abundant documentation from many witnesses who have appeared before this Committee as to the abuses suffered by limited partners caught in the rising number of roll-ups.

As many of you know, NASAA and its members do not hesitate to call for a more effective state and Federal sharing of the response to a truly national problem. Today, we are faced with another such problem in roll-ups. State securities agencies are willing to do their part in working with the Congress, the SEC and the self-

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[11] House Report 103-21, Committee on Energy and Commerce, to accompany H.R. 617, the Limited Partnership Rollup Reform Act of 1993, February 25, 1993, p. 28.

regulatory organizations to end the current abuses. Such "teamwork," under which all the oars will be pulling together, represents the best hope for bringing an end to this systematic attack on small investors. Accordingly, NASAA respectfully urges the swift adoption of S. 424.

Thank you.

103D CONGRESS
1ST SESSION

S. 424

To amend the Securities Exchange Act of 1934 with respect to limited partnership rollups.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 24 (legislative day, JANUARY 5), 1993

Mr. DODD (for himself, Mr. RIEGLE, Mr. D'AMATO, Mr. SARBANES, Mr. BOND, Mr. SASSER, Mr. SHELBY, Mr. KERRY, Mr. BRYAN, Mr. DOMENICI, Mrs. BOXER, Mrs. MURRAY, Ms. MIKULSKI, Mr. ROBB, Mr. LEAHY, Mr. INOUYE, Mr. SIMON, Mr. KERREY, Mr. LEVIN, Mr. HOLLINGS, Mr. HARKIN, Mr. AKAKA, Mr. LAUTENBERG, Mr. BRADLEY, Mr. JEFFORDS, Mr. PRYOR, Mr. KOHL, Mr. GRAHAM, Mr. CONRAD, Mr. BOREN, Mr. BINGAMAN, and Mr. WOFFORD) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing and Urban Affairs

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A BILL

To amend the Securities Exchange Act of 1934 with respect to limited partnership rollups.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Limited Partnership Rollup Reform Act of 1993".

SEC. 2. REVISION OF PROXY SOLICITATION RULES WITH RESPECT TO LIMITED PARTNERSHIP ROLLUP TRANSACTIONS.

(a) AMENDMENT.—Section 14 of the Securities and Exchange Act of 1934 (15 U.S.C. 78n) is amended by adding at the end the following new subsection:

"(h) PROXY SOLICITATIONS AND TENDER OFFERS IN CONNECTION WITH LIMITED PARTNERSHIP ROLLUP TRANSACTIONS.—

"(1) PROXY RULES TO CONTAIN SPECIAL PROVISIONS.—It shall be unlawful for any person to solicit any proxy, consent, or authorization concerning a limited partnership rollup transaction, or to make any tender offer in furtherance of a limited partnership rollup transaction, unless such transaction is conducted in accordance with rules prescribed by the Commission under sections 14(a) and 14(d), as required by this subsection. Such rules shall—

"(A) permit any holder of a security that is the subject of the proposed limited partnership rollup transaction to engage in preliminary communications for the purposes of determining whether to solicit proxies, consents, or authorizations in opposition to the proposed transaction, without regard to whether any such communication would otherwise be considered a

solicitation of proxies, and without being required to file soliciting material with the Commission prior to making that determination, except that nothing in this subparagraph shall be construed to limit the application of any provision of this title prohibiting, or reasonably designed to prevent, fraudulent, deceptive, or manipulative acts or practices under this title;

"(B) require the issuer to provide to holders of the securities that are the subject of the transaction such list of the holders of the issuer's securities as the Commission may determine in such form and subject to such terms and conditions as the Commission may specify;

"(C) prohibit compensating any person soliciting proxies, consents, or authorizations directly from security holders concerning such a transaction—

"(i) on the basis of whether the solicited proxies, consents, or authorizations either approve or disapprove the proposed transaction; or

"(ii) contingent on the transaction's approval, disapproval, or completion;

"(D) set forth disclosure requirements for soliciting material distributed in connection with a limited partnership rollup transaction, including requirements for clear, concise, and comprehensible disclosure, with respect to—

"(i) any changes in the business plan, voting rights, form of ownership interest or the general partner's compensation in the proposed limited partnership rollup transaction from each of the original limited partnerships;

"(ii) the conflicts of interest, if any, of the general partner;

"(iii) whether it is expected that there will be a significant difference between the exchange values of the limited partnerships and the trading price of the securities to be issued in the limited partnership rollup transaction;

"(iv) the valuation of the limited partnerships and the method used to determine the value of limited partners' interests to be exchanged for the securities in the limited partnership rollup transaction;

"(v) the differing risks and effects of the transaction for investors in different limited partnerships proposed to be included, and the risks and effects of completing the transaction with less than all limited partnerships;

"(vi) a statement by the general partner as to whether the proposed limited partnership rollup transaction is fair or unfair to investors in each limited partnership, a discussion of the basis for that conclusion, and the general partner's evaluation, and a description, of alternatives to the limited partnership rollup transaction, such as liquidation;

"(vii) any opinion (other than an opinion of counsel), appraisal, or report received by the general partner or sponsor that is prepared by an outside party and that is materially related to the limited partnership rollup transaction and the identity and qualifications of the party who prepared the opinion, appraisal, or report, the method of selection of such party, material past, existing, or contemplated rela-

tionships between the party, or any of its affiliates and the general partner, sponsor, successor, or any other affiliate, compensation arrangements, and the basis for rendering and methods used in developing the opinion, appraisal, or report; and

"(viii) such other matters deemed necessary or appropriate by the Commission;

"(E) provide that any solicitation or offering period with respect to any proxy solicitation, tender offer, or information statement in a limited partnership rollup transaction shall be for not less than the lesser of 60 calendar days or the maximum number of days permitted under applicable State law; and

"(F) contain such other provisions as the Commission determines to be necessary or appropriate for the protection of investors in limited partnership rollup transactions.

The disclosure requirements under subparagraph (D) shall also require that the soliciting material include a clear and concise summary of the limited partnership rollup transaction (including a summary of the matters referred to in clauses (i) through (vii) of that subparagraph) with the risks of the limited

partnership rollup transaction set forth prominently in the fore part thereof.

"(2) EXEMPTIONS.—The Commission may, consistent with the public interest, the protection of investors, and the purposes of this title, exempt by rule or order any security or class of securities, any transaction or class of transactions, or any person or class of persons, in whole or in part, conditionally or unconditionally, from the requirements imposed pursuant to paragraph (1) or, from the definition contained in paragraph (4).

"(3) EFFECT ON COMMISSION AUTHORITY.—Nothing in this subsection limits the authority of the Commission under subsection (a) or (d) or any other provision of this title or precludes the Commission from imposing, under subsection (a) or (d) or any other provision of this title, a remedy or procedure required to be imposed under this subsection.

"(4) DEFINITION.—As used in this subsection the term 'limited partnership rollup transaction' means a transaction involving—

"(A) the combination or reorganization of limited partnerships, directly or indirectly, in which some or all investors in the limited part-

nerships receive new securities or securities in another entity, other than a transaction—

"(i) in which—

"(I) the investors' limited partnership securities are reported under a transaction reporting plan declared effective before January 1, 1991, by the Commission under section 11A; and

"(II) the investors receive new securities or securities in another entity that are reported under a transaction reporting plan declared effective before January 1, 1991, by the Commission under section 11A;

"(ii) involving only issuers that are not required to register or report under section 12 both before and after the transaction;

"(iii) in which the securities to be issued or exchanged are not required to be and are not registered under the Securities Act of 1933;

"(iv) which will result in no significant adverse change to investors in any of

the limited partnerships with respect to voting rights, the term of existence of the entity, management compensation, or investment objectives; or

"(v) where each investor is provided an option to receive or retain a security under substantially the same terms and conditions as the original issue; or

"(B) the reorganization of a single limited partnership in which some or all investors in the limited partnership receive new securities or securities in another entity, and—

"(i) transactions in the security issued are reported under a transaction reporting plan declared effective before January 1, 1991, by the Commission under section 11A;

"(ii) the investors' limited partnership securities are not reported under a transaction reporting plan declared effective before January 1, 1991, by the Commission under section 11A;

"(iii) the issuer is required to register or report under section 12, both before and after the transaction, or the securities to

be issued or exchanged are required to be or are registered under the Securities Act of 1933;

"(iv) there are significant adverse changes to security holders in voting rights, the term of existence of the entity, management compensation, or investment objectives; and

"(v) investors are not provided an option to receive or retain a security under substantially the same terms and conditions as the original issue.

"(5) EXCLUSION.—For purposes of this subsection, a limited partnership rollup transaction does not include a transaction that involves only a limited partnership or partnerships having an operating policy or practice of retaining cash available for distribution and reinvesting proceeds from the sale, financing, or refinancing of assets in accordance with such criteria as the Commission determines appropriate.".

(b) SCHEDULE FOR REGULATIONS.—The Securities and Exchange Commission shall, not later than 12 months after the date of enactment of this Act, conduct rulemaking proceedings and prescribe final regulations under

the Securities Act of 1933 and the Securities Exchange Act of 1934 to implement the requirements of section 14(h) of the Securities Exchange Act of 1934, as amended by subsection (a).

SEC. 3. RULES OF FAIR PRACTICE IN ROLLUP TRANSACTIONS.

(a) REGISTERED SECURITIES ASSOCIATION RULE.—Section 15A(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–3(b)) is amended by adding at the end the following new paragraph:

"(12) The rules of the association to promote just and equitable principles of trade, as required by paragraph (6), include rules to prevent members of the association from participating in any limited partnership rollup transaction (as such term is defined in paragraphs (4) and (5) of section 14(h)) unless such transaction was conducted in accordance with procedures designed to protect the rights of limited partners, including—

"(A) the right of dissenting limited partners to an appraisal and compensation or other rights designed to protect dissenting limited partners;

"(B) the right not to have their voting power unfairly reduced or abridged;

"(C) the right not to bear an unfair portion of the costs of a proposed rollup transaction that is rejected; and

"(D) restrictions on the conversion of contingent interests or fees into non-contingent interests or fees and restrictions on the receipt of a non-contingent equity interest in exchange for fees for services which have not yet been provided.

As used in this paragraph, the term 'dissenting limited partner' means a holder of a beneficial interest in a limited partnership that is the subject of a limited partnership rollup transaction who casts a vote against the transaction and complies with procedures established by the association, except that for purposes of an exchange or tender offer, such term means any person who files an objection in writing under the rules of the association during the period in which the offer is outstanding and complies with such other procedures established by the association.".

(b) LISTING STANDARDS OF NATIONAL SECURITIES EXCHANGES.—Section 6(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78f(b)) is amended by adding at the end the following:

"(9) The rules of the exchange prohibit the listing of any security issued in a limited partnership rollup transaction (as such term is defined in paragraphs (4) and (5) of section 14(h)), unless such transaction was conducted in accordance with procedures designed to protect the rights of limited partners, including—

"(A) the right of dissenting limited partners to an appraisal and compensation or other rights designed to protect dissenting limited partners;

"(B) the right not to have their voting power unfairly reduced or abridged;

"(C) the right not to bear an unfair portion of the costs of a proposed rollup transaction that is rejected; and

"(D) restrictions on the conversion of contingent interests or fees into non-contingent interests or fees and restrictions on the receipt of a non-contingent equity interest in exchange for fees for services which have not yet been provided.

As used in this paragraph, the term 'dissenting limited partner' means a holder of a beneficial interest in a limited partnership that is the subject of a lim-

ited partnership transaction who casts a vote against the transaction and complies with procedures established by the exchange, except that for purposes of an exchange or tender offer, such term means any person who files an objection in writing under the rules of the exchange during the period in which the offer is outstanding.".

(c) STANDARDS FOR AUTOMATED QUOTATION SYSTEMS.—Section 15A(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-3(b)) is amended by adding at the end the following new paragraph:

"(13) The rules of the association prohibit the authorization for quotation on an automated interdealer quotation system sponsored by the association of any security designated by the Commission as a national market system security resulting from a limited partnership rollup transaction (as such term is defined in paragraphs (4) and (5) of section 14(h)), unless such transaction was conducted in accordance with procedures designed to protect the rights of limited partners, including—

"(A) the right of dissenting limited partners to an appraisal and compensation or other rights designed to protect dissenting limited partners;

"(B) the right not to have their voting power unfairly reduced or abridged;

"(C) the right not to bear an unfair portion of the costs of a proposed rollup transaction that is rejected; and

"(D) restrictions on the conversion of contingent interests or fees into non-contingent interests or fees and restrictions on the receipt of a non-contingent equity interest in exchange for fees for services which have not yet been provided.

As used in this paragraph, the term 'dissenting limited partner' means a holder of a beneficial interest in a limited partnership that is the subject of a limited partnership transaction who casts a vote against the transaction and complies with procedures established by the association, except that for purposes of an exchange or tender offer such term means any person who files an objection in writing under the rules of the association during the period during which the offer is outstanding.".

(d) EFFECT ON EXISTING AUTHORITY.—The amendments made by this section shall not limit the authority of the Securities and Exchange Commission, a registered securities association, or a national securities exchange

under any provision of the Securities Exchange Act of 1934, or preclude the Commission or such association or exchange from imposing, under any other such provision, a remedy or procedure required to be imposed under such amendments.

(e) EFFECTIVE DATE.—The amendments made by this section shall become effective 18 months after the date of enactment of this Act.

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WRITTEN SUBMISSION FROM ROBERT FRATER, HOUSTON, TX

Over the course of 1981–1983 I invested in a number of limited partnerships in oil and gas, equipment leasing, and real estate. These investments include Equitec, PLM, and Columbian. Several years after my investments, all of these particular partnerships were subjected to roll-ups under the guise of saving money for the investor. Though these are separate limited partnerships with separate general partners, there were similarities in these roll-ups.

Similarity #1: All of these roll-ups were forced upon the investors by the general partners who offered commissions to the brokers to induce "yes" votes only. All information provided was extremely one-sided, causing the "no" vote to appear unpalatable. Despite all of the propaganda, after I endured the first roll-up, I voted against all of the remainder to no avail.

Similarity #2: In every situation, the general partner took advantage of the opportunity to take substantial compensation from the partnership. In fact, the compensation was far greater than the general partner would have received had the roll-up not taken place. In addition, the general partner built in new fees and reimbursements after the roll-up to make the new entity more profitable for the general partner.

Similarity #3: The nature of the investment was changed so dramatically that it did not resemble what I had initially invested in. The Columbian and Equitec investments are now practically dead. However, the PLM is the worst of all. PLM was performing well until it was rolled-up. It was converted to a corporation and issued stock to the investors subjecting us to substantial tax penalties because of the involuntary conversion of assets (from a limited partnership to a corporation) in which we had taken investment tax credit.

The new corporation has consistently lost money because of the substantial benefit packages (profit sharing plans, deferred compensation, incentive bonuses, etc.), the general partners continue to take from the corporation as if they had not already sucked enough of the lifeblood from the investment when it was converted. I must now read in the quarterly statements about the substantial income the investments are making, but are being sucked out by the old general partner and so my investment has a net loss and a decreasing asset value.

Roll-ups as we know them now are at best a violation of the "trust" the limited partners place in the hands of a general partner to do what is right on their behalf. The partnership format gives the general partner a tremendous amount of fiduciary responsibility, and an investor bases his investment on the information provided in the prospectus. A properly written prospectus limits the abilities of the general partner to very specific activities which will benefit the limited partners.

Roll-ups allow the general partner to re-write his meal ticket any way he wants to General partners have definitely shown us they have no hesitation to breach that fiduciary responsibility once they have your money and can re-write the rules they're held accountable by.

Legislation is needed to hold these general partners to at least the fiduciary standard of the original document. Anything less, and the roll-up will continue to be a license to steal. I would strongly encourage the Banking Committee to endorse anti-roll-up legislation to prevent this kind of activity in the future.

TESTIMONY OF JAY E. FISHMAN, ASA

CHAIRMAN, BUSINESS VALUATION COMMITTEE, AMERICAN SOCIETY OF APPRAISERS

I. Introduction

ASA is a national professional appraisal organization with 6,000 members in the 50 states. Established in 1936, it is the nation's largest multi-disciplinary appraisal society (e.g., real property, personal property and business valuation appraisers) that teaches, tests and privately designates its members for professional achievement.

ASA designated business valuation appraisers are preeminent in the field of valuing business enterprises, machinery and equipment, and tangible and intangible personal property assets. The Society provides comprehensive education and training courses in these valuation areas not only to appraisers but to CPAs, consulting and law firms, and to government agencies like the IRS. ASA business valuation appraisers have provided appraisal services in connection with some rollup transactions.

II. Executive Summary

The American Society of Appraisers strongly supports S. 424. As appraisal professionals, ASA members are acutely sensitive to the complexities of rollup transactions and the financial vulnerability of limited partners on matters involving the valuation of existing and proposed partnership enterprises and their assets. We believe that the key to protecting limited partners in a proposed reorganization is to provide assurance that the business enterprises subject to the rollup and the assets of those enterprises are valued *independently and uniformly* by individuals who possess the education and training to do so.

In the absence of an objective appraisal of the value of an existing limited partnership and its assets, it is impossible for rollup sponsors to render a responsible "fairness opinion"; and impossible for investors to answer the following central questions concerning a proposed rollup:

First, will I be better off financially if the assets of the existing enterprise are sold rather than accepting an equity interest in a successor enterprise? And,

Second, if the answer to the first question appears to be "no," will the ownership interest I receive in the successor entity be fair consideration given the value of my ownership interest in the existing partnership (i.e., exchange value)?

S. 424 goes a long way toward creating the conditions under which a responsible fairness opinion can be rendered and the limited partners will be able to answer those key questions: the bill protects the rights of dissenting limited partners to ". . . an appraisal and compensation . . ."; and it mandates *disclosure* of ". . . methods used to determine the value of limited partners' interests to be exchanged . . ." and of the ". . qualifications of the party who prepared the . . . appraisal. . . ."

We are concerned, however, that S. 424 does not mandate the use of uniform appraisal methodologies to determine values, even as to like partnerships or assets; does not set any minimum qualification requirements for individuals performing rollup related appraisals; and, does not provide any mechanism for making appraisers accountable for their decisions,

ASA does not believe that disclosure alone of appraisal methodologies and appraiser qualifications alone is sufficient to protect the interests of limited partners. The valuation of partnership enterprises and their tangible and intangible assets is a complex process. It is highly unlikely that investors would be enlightened or their rollup decisionmaking enhanced merely by virtue of a disclosure of the methodologies and assumptions applied to an appraisal of existing and future partnership interests.

Consider, for example, the adverse impact on investor protection of a regulatory policy which permitted the use of *any* accounting methodologies to establish an enterprise's financial condition (rather than Generally Accepted Accounting Principles [GAAP]) so long as the methodology utilized was disclosed; or which permitted *any individual* (rather than an accountant) to apply that methodology, so long as his or her training was disclosed.

ASA believes that adherence to uniform appraisal standards by individuals performing valuations in connection with rollups is as crucial to investor protection as adherence to GAAP by individuals performing accounting services.

Accordingly, **ASA recommends that S. 424 be amended in the following two ways:**

(1) To require the SEC to adopt uniform appraisal standards for the valuation of partnerships and their assets in connection with rollup proposals;

In this regard, we wish to point out that uniform appraisal standards covering the valuation of real property, tangible and intangible personal property, and business enterprises, are already in existence. Indeed, the *Uniform Standards of Professional Appraisal Practice* (USPAP), promulgated by the Standards Board of the nonprofit Appraisal Foundation, are currently recognized by most Federal agencies for real estate related financial transactions which are backed, directly or indirectly, by the United States. A copy of USPAP is enclosed for the Committee's consideration.

We also note that the NASD's newly adopted rollup rules (which provide for an independent appraisal of the value of the partnership assets on behalf of dissenting limited partners) were amended, in response to members' comments, to include a requirement "that the appraisal be done in a manner that is consistent with appropriate industry practice." **Adoption of uniform appraisal standards would effectuate and give meaning to NASD's requirement;** and,

(2) To require the SEC to work with the Appraisal Foundation's Qualifications Board for the purpose of establishing minimum competency requirements for individuals performing appraisals in rollup situations; and

(3) To require the SEC to adopt an SEC-supervised, self-certification system for appraisers involved in rollups for the purpose of assuring that their valuations comply with USPAP, including its Competency Provision. That Provision "requires an appraiser to have both the knowledge and the experience required to perform a specific appraisal service competently"; and, if such knowledge and experience is lacking, to disclose that fact to his or her client.

III. The Role of Appraisals In Rollup Transactions

ASA submitted formal comments to the SEC when it proposed its rollup reform rules in the summer of 1991. One of the key points made was that while competent and independent appraisals are crucial to protecting the interests of limited partners, the SEC proposed rule failed to establish any meaningful requirements relative to the valuation standards or methodologies that appraisers should follow in valuing businesses or assets; and failed to establish any minimum qualifications requirements for individuals conducting rollup-related appraisals. ASA opined that SEC proposed requirements calling for **public disclosure** of appraisal methodologies and the qualifications of those performing the appraisals, would have little or no meaning to most investors and would not protect them from "advocacy appraisals" in support of those promoting approval of the reorganizations.

ASA argued that the establishment of **uniform** appraisal requirements was as crucial to investor protection in rollup situations as existing SEC requirements for adherence, by accountants, to Generally Accepted Accounting Principles (GAAP). Accordingly, ASA urged the SEC to mandate the use of generally accepted valuation methodologies in connection with rollups.

In this regard, we pointed out:

—that uniform appraisal standards governing real property, business valuation and personal property already were in place (the *Uniform Standards of Professional Appraisal Practice* [USPAP] established by the Appraisal Standards Board of the nonprofit Appraisal Foundation); and,

—that most agencies of the Federal government have adopted USPAP's real property standards in connection with real estate related financial transactions for which the government was at risk. The Foundation's uniform standards are recognized in Title XI of FIRREA and pursuant to OMB Directive.

ASA believes that without the establishment of uniform appraisal standards and some minimum skill requirements for those performing appraisals, investor protections for limited partners in rollup transactions will be severely undermined. It is for this reason that ASA urges Congress to do what the SEC has failed to do—mandate a process leading to the adoption of uniform appraisal standards and minimum competency requirements when appraisals are performed in rollup transactions.

IV. The SEC's Failure To Adopt Uniform Appraisal Requirements For Rollups Is At Variance With Appraisal Reforms Which Have Been Adopted Throughout the Federal Government

We believe that current Federal policies relating to the appraisal of real property establish an important precedent for the SEC's adoption of USPAP in connection with rollups. Congress has determined in Title XI of FIRREA and, subsequently, the Office of Management and Budget has affirmed (by its extension of Title XI on a government-wide basis) that taxpayer interests are best protected by requiring adherence to uniform appraisal methodologies (i.e., USPAP) and by the use of professional appraisers in federally related transactions (i.e., certified and licensed appraisers).

Frankly, we do not understand why the SEC has failed to join the rest of the Federal government in requiring adherence to USPAP and the use of state certified or licensed appraisers in rollup and other regulated transactions in which the valuation of *real property* is a material factor in investor decisionmaking.

If the SEC's real property appraisal requirements were consistent with those of most other Federal agencies and the major assets of a partnership scheduled to undergo a rollup were real property assets, then limited partners would benefit from a market value appraisal of those assets by a state certified or licensed real property appraiser in accordance with USPAP. In fact, if the purchase of real property assets by an SEC regulated partnership were financed by a loan from a federally insured financial institution, a certified or licensed appraisal would currently be required pursuant to FIRREA.

V. NASD-Member Comment Letters On Rollup Protections Urged Adoption of Uniform Appraisal Standards

Evidence of the need for uniform appraisal standards and minimum skill requirements in rollup situations is provided in many of the comment letters sent to, NASD by its members in response to its proposed rulemaking on rollups. Numerous commenters stated that appraisers should be required to meet minimum professional standards and that appraisal methodologies should be carefully developed: For example,

—The American Association of Limited Partners, in its January 31, 1993, letter to NASD stated "**Appraisal standards.** It is essential that an appraiser (1) meet minimum professional standards; (2) is financially independent from the general partner(s) sponsoring the deal; and (3) meet minimum financial standards. It would be unfortunate if such standards were not put in place to ensure that appraisals are meaningful and truly independent from the general partner(s)."

—The Iowa Department of Commerce, on behalf of the North American Securities Administrators Association (NASAA), pointed out that NASAA's Guidelines for direct participation programs relating to rollups contain much more detailed requirements for appraisal standards and appraiser independence than does the NASD proposal: "In connection with a proposed rollup, an appraisal of all program assets shall be obtained from a competent, independent expert. . . . [Additionally], the NASAA language requires that the appraisal assume that program assets are to be liquidated in an orderly fashion over a period of one year . . . the NASAA language includes a definition that spells out the required level of appraiser independence. . . ."

—Baker & Botts, on behalf of Paine Webber, stated that a subsection of the NASD's rollup amendments (Section 6(c)(2)(i)(B)) "would require the valuation of limited partnership interests in a rollup context to follow valuation methods specified in a partnership agreement for use in entirely different contexts. . . . Such provisions are included in a partnership agreement for particular reasons and the valuation formula may not be fair if the reasons for their existence are not present. Limited partners are unlikely to be protected by forcing adherence to these possibly inapplicable valuation methods. . . . This subsection, if retained would, in the case of a rollup involving several partnerships likely increase the complexity of the rollup prospectus, increase costs and possibly result in disparate treatment of partnerships that have substantially the same values. . . ."

—The president of MONY Securities Corporation commented to NASD ". . . that the appraisal process is key to what follows [in a rollup] and in my opinion, the NASD should exercise as much control over the appraisal process as is within your purview. Second, a review and reappraisal of the proposed securities to be traded for the original limited partnership interest is as important as the first appraisal."

—Mutual Service Corporation of Florida wrote that "Qualifications should be established for the provider of the independent appraisal services required for establishing compensation (e.g., three to five years of experience, member of appraisal organization, etc.).

Copies of some of these letters are attached. As indicated earlier, NASD responded to the comment letters by requiring that appraisals be performed in accordance with industry practice.

VI. Self-Serving Appraisals Have Been An Endemic Problem In Rollups

A number of financial writers and many witnesses at Congressional hearings into rollups have voiced concerns about the self-serving nature of appraisals performed by or for general partners:

—Arizona's Division of Securities testified before the Senate Securities Subcommittee in 1991 that "the disclosure currently provided in rollups . . . is rendered all but meaningless because of the misleading of limited partners **through the use of . . . artificially generated appraisals. . . .**"

—The May 19, 1990, issue of "Financial Planning," quoted the owner of *National Partnership Marketplace* (described as a "seasoned rollup insider" who "worked as a consultant on the two largest rollups ever") to the effect that "Some rollup sponsors inflate like crazy to make the appraised value [of a future entity] match the per-unit price [the general partner needs] to make the rollup look good.

—A Federal District Court concluded in a Tender Offer case that appraisers working for First American Bankshares offered the minority stockholder of First American

Bank of Virginia, a value for their shares that was appraised improperly by individuals working for the acquiring institution, at $18.00 a share *less* than it should have been under appropriate appraisal standards.

—In a November 1987 "Barron's" article, Benjamin Stein described the "stealth takeover" of the machinery and equipment assets of several limited partnerships. Stein analyzed the appraisal process which established the value of the firm's shares. He characterized the process as "self-serving" and based totally on "unrealistic assumptions."

VII. Conclusion

ASA strongly supports immediate adoption, by the SEC, of the *Uniform Standards of Professional Appraisal Practice* in connection with rollup-related valuations. **Absent agreement on the use of industry-wide uniform standards for valuing partnerships and their assets, appraisal results will vary widely even as to like partnerships and assets; and will be subject to manipulation in support of rollup proposals.**

ASA also urges that the SEC be tasked with responsibility for working with the Appraisal Foundation's Qualifications Board for the purpose of:

—developing minimum competency criteria for appraisers in rollup situations; and

—an enforcement system based on self-certification by appraisers that their valuations are in compliance with USPAP, including its Competency Provision.

Although the Appraisal Foundation is the proper forum for establishing appraisal standards and appraiser qualification requirements for SEC-regulated transactions, we recognize that the SEC should retain the authority to override Foundation decisions relative to standards and competency—just as the bank regulatory agencies do with respect to Title XI real property appraisal standards and appraiser competency.

In essence, the appraisal system would work, vis-a-vis the SEC, in much the same way that the accounting system works.

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